

Allocating the Risk of the Unforeseen, Subsurface and Latent Conditions in Construction Contracts: Is There Room for the Common Law?

Hazel Glenn Beh*

I. INTRODUCTION

In Jacksonville, Florida, a city official complains that contractors "low bid contracts only to pile up thousands of dollars in change orders later."¹ In Honolulu, Hawaii, a city council member grills a city planner as to how a fixed-price contract for simple renovations to a Waikiki fountain doubled from the original award.² The planner sheepishly explains the water table was higher than expected, and the council member throws up her hands in exasperation.³ In Buffalo, New York, a public works commissioner reports that overall, road projects average fourteen percent over budget and "questions whether low bidders deliver the most inexpensive work."⁴ There is no disputing that fixed-price government construction contracts frequently run well over budget.⁵ A mischievous clause, found in most government contracts, called the differing site condition provision, is a principal reason behind the additional costs. This clause undermines the concept of a fixed-price contract. It leaves a jaded, cynical public shaking its head as government owners pay for costs associated with unforeseen conditions discovered during contract

* Assistant Professor of Law, William S. Richardson School of Law, University of Hawaii at Manoa.

1. See Martin Wisckol, *City Eyes Change to Low-Bid Rule*, FLA. TIMES-UNION, May 21, 1996, at B1.

2. See Budget Committee, City Council, City and County of Honolulu, *Minutes*, at 7 (Feb. 26, 1997) (noting discussion for the record) (video archived with City Council, City and County of Honolulu).

3. See *id.*

4. See Margaret Hammersley, *Overruns on Highway, Bridge Projects Cost County \$9 Million During 1988-93*, BUFFALO NEWS, Dec. 15, 1994, at Local 5.

5. See, e.g., R.B. Brenner, *A Dream Is Set in Concrete, Foundation Being Poured for City Convention Center*, SAN DIEGO UNION-TRIB., May 5, 1987, at B1 (discussing excavator's changed condition claim of \$10.9 million); Scott McKeen, *Firm Seeks \$12M More for Dam Job; Says 'Changed Conditions' Helped Boost Cost of Oldman Work*, EDMONTON J. (Canada), Apr. 5, 1990, at A7; Barry Noreen, *Mediator May Be Asked to Settle Dispute Between City, Contractor/Cost, Delays Affect 3.3-Mile Water Tunnel*, COLO. SPRINGS GAZETTE TELEGRAPH, June 30, 1989, at B3; David Willman, *Mistakes, Problems Add Millions to Subway Cost Metro Rail: The Red Line Is Running About \$200 Million over Budget. It May Be Costliest Such Project in U.S.*, L.A. TIMES, Nov. 16, 1993, at 1.

performance. While the average person might think that the problem of cost overruns is unique to the government, little does he or she know that the differing site condition provision is found in standard form construction contracts throughout the industry. In fact, as a result of this often litigated clause, average individuals may find their simple home renovation or construction project costs escalating beyond the fixed price stipulated in their contracts.

Such examples are typical in construction projects, which, by their very nature, are plagued by unforeseen circumstances. Construction contract documents generally reflect a conscious effort to anticipate the unexpected and to allocate the risk so the project can go forward. The differing site condition provision serves that goal by reallocating risk to owners and by requiring owners to modify contracts during performance to account for changing circumstances.⁶ The provision represents a reasoned and deliberate risk-allocation decision by the federal government.⁷ However, the federal government has also imposed the clause upon states and municipalities receiving federal money for construction projects.⁸ The roots of this provision rest in federal procurement law; however, similar provisions are now the stock and trade of fixed-price construction contracts.⁹

In Part II, this Article reviews both the common law treatment of risks associated with differing site conditions discovered mid-performance and the rationale for placing all such risks on contractors. Part III examines

6. See *infra* note 42 and accompanying text.

7. See *infra* note 79 and accompanying text.

8. See 40 C.F.R. § 35.938-8 & app. C-2 (1996); see also *Municipality of Anchorage v. Frank Coluccio Constr. Co.*, 826 P.2d 316, 318 (Alaska 1992) (stating that a municipality receiving federal funding was required to include differing site condition provision); *City of Morton v. Minnesota Pollution Control Agency*, 437 N.W.2d 741, 743 (Minn. App. 1989) ("The federal regulations establish minimum requirements for state and local procurement systems. . . . Each construction contract . . . must include certain contract provisions, including a clause allowing the contractor an equitable contract price adjustment for unforeseen site conditions."); Lewis J. Baker, *Procurement Disputes at the State and Local Level: A Hodgepodge of Remedies*, 25 PUB. CONT. L.J. 265, 284-85 (1996) (describing various federal requirements on awards to state and local government public works grantees); F. Trowbridge Vom Baur, *A Personal History of the Model Procurement Code*, 25 PUB. CONT. L.J. 149, 161 (1996) (discussing federal policy).

9. See *infra* note 84 and accompanying text. The question of whether standard form clauses are fair is particularly timely because there is some movement toward a uniform construction code. "At its national convention held in March 1995, the Board of Directors of the AGC [Associated General Contractors of America] adopted the recommendation of the Contract Documents Committee that the AGC express a willingness to assist the ABA Forum Committee in exploring the possibility of creating a uniform construction code." Mark L. McAlpine & David A. Breuch, *A Uniform Construction Law Code: Is There a Foundation to Build on?* 74 MICH. B.J. 554, 558 n.2 (1995).

The form contracts promulgated by the American Institute of Architects (AIA), in particular, "essentially embody the working relationships within the construction industry." Gene Ming Lee, *A Case for Fairness in Public Works Contracting*, 65 FORDHAM L. REV. 1075, 1076-77 (1996).

the impact of the differing site condition provision upon two common law risk-allocation rules and explores the normative and economic rationales for shifting most risks to the owner, especially as applied to large public and private entities regularly engaged in construction contracting. For those public and private entities that voluntarily elect to use the differing site condition provision as a risk-allocation tool, this Article proposes certain modest changes to the current clause, moving toward a risk-sharing model. By risk-sharing rather than risk-allocating unforeseen conditions, contractors will have less incentive to bid inaccurately, owners will have more incentive to disclose information about sites, and all parties will have less motivation to litigate claims.

Finally, the Article questions the rationales for inclusion of the provision in construction contracts of small municipalities and private owners, both of which enter the construction market less often or enjoy fewer financial reserves with which to bear the risks the clause allocates to them.¹⁰ Therefore, this Article suggests that standard form construction contract documents provide contractual choices so that contractors and owners negotiate the issue of who should bear the cost of differing site conditions.

II. THE COMMON LAW TREATMENT OF DIFFERING SITE CONDITIONS ON CONSTRUCTION PROJECTS

Two common law rules favor the owner and disfavor the contractor when unforeseen conditions create additional expenses during the performance of a construction contract. First, in a fixed-price contract, the common law allocates the risk of additional expenses due to unforeseen conditions to the contractor. Second, even if the owner desired to voluntarily modify the contract to account for the additional expenses, the traditional pre-existing duty rule poses a formidable obstacle because the new promise is unsupported by consideration.

10. See John F. McGuinn, *Use and Abuse of Risk Allocation in the Construction Industry*, in 1 ALLOCATING RISKS IN TODAY'S CONSTRUCTION: A SEARCH FOR FAIRNESS AND SOLUTION 1, 5-6 (1989) (A.B.A. Forum on the Construction Industry, Fifth Annual Meeting) (calling for reform in risk-allocation process); Lee, *supra* note 9, at 1118 (calling for reform in competitive public bid contracts, saying "[t]he government should pay for all contingent conditions when and if they are encountered," and arguing that "contractors are not capable of taking on this risk").

A. Differing Site Conditions and the Common Law: No Relief for the Contractor

The common law affords tremendous risk protection to an owner against demands for additional compensation by a contractor because of unforeseen subsurface and latent conditions on the owner's property. The general rule is that no matter how onerous the burden, once a contractor has promised to perform, any added expense caused by unforeseen conditions is allocated to the contractor. The early, well-known case of *Stees v. Leonard*¹¹ is illustrative. Mr. Stees contracted with Mr. Leonard, an architect-builder, to erect a three-story business on Mr. Stees' property.¹² When the structure was nearly completed, it collapsed because the soil retained too much water and could not support the structure's weight.¹³ Indeed, the evidence suggested that the soil was like "quicksand," "soft, slippery, porous and unsafe."¹⁴ Mr. Leonard attempted to rebuild the structure for Mr. Stees, but when the building was near completion it collapsed again.¹⁵ Mr. Leonard abandoned the project and refused to perform under the contract.¹⁶ Mr. Stees filed suit, seeking 1) return of his progress payments, 2) damages for the loss of use of the land, and 3) damages for injury to adjacent property that the falling building caused.¹⁷ Mr. Leonard defended the suit by blaming Mr. Stees for failing to provide a suitable location upon which to build.¹⁸ Although each blamed the other, the facts suggested that neither Mr. Stees nor Mr. Leonard knew or could have known that lurking below the placid surface of the street was an underground monster capable of swallowing a three-story building in a single gulp.¹⁹

11. 20 Minn. 494 (1874).

12. *See id.* at 496.

13. *See id.*

14. *Id.* at 498.

15. *See id.* at 497.

16. *See id.*

17. *See id.*

18. *See id.* at 499.

19. Monsters still lurk beneath the ground. Consider the following:

As soon as the concrete was poured, it disappeared.

While puzzled construction workers looked on, wet cement -- which was supposed to form underground support piers for new buildings at the city's Southside Sewage Treatment Plant seeped by the ton into marshy earth.

....
 "The concrete dropped two feet, three feet, five feet, 10 feet in the hole," said Jim Milstead, Dallas Water Utilities' project manager . . .

....
 A project that was supposed to be an example of environmental responsibility became, by the end of 1986, a mess.

In *Stees* the court announced a rule, still followed today absent contractual agreement to the contrary, that protects the property owner from the risks of unforeseen conditions and holds the contractor to its word regardless of the burden:

The general principle of law which underlies this case, is well established. If a man bind himself, by a positive, express contract, to do an act in itself possible, he must perform his engagement, unless prevented by the act of God, the law, or the other party to the contract. No hardship, no unforeseen hindrance, no difficulty short of absolute impossibility, will excuse him from doing what he has expressly agreed to do. This doctrine may sometimes seem to bear heavily upon contractors; but, in such cases, the hardship is attributable, not to the law, but to the contractor himself, who has improvidently assumed an absolute, when he might have taken only a qualified liability.²⁰

Mr. Stees won a money judgment based upon Mr. Leonard's breach of promise to erect a building.²¹ The rule remains that if the construction of the promised object is not impracticable²² then the contractor must perform, even if continuation of the project might far exceed the anticipated cost of completion.²³

Bruce Tomaso, *Sewage Plant Expansion Started Badly, Got Worse*, DALLAS MORNING NEWS, Aug. 8, 1987, at 33A (detailing a changed condition claim).

20. *Stees*, 20 Minn. at 503. The building could apparently have been built if "stronger foundations" had been used, the land drained, and then continuously drained during construction. *See id.* at 508. One aspect of the dispute was which party had agreed to keep the soil drained after the problem was discovered during construction. *See id.* The pre-existing duty rule precluded the court from affixing blame to Mr. Stees for his alleged promise during performance of the contract to keep the soil drained during construction. *See id.* at 510.

21. *See id.* at 500.

22. The RESTATEMENT (SECOND) OF CONTRACTS § 266(1) (1981) states:

Where, at the time a contract is made, a party's performance under it is impracticable without his fault because of a fact of which he has no reason to know and the non-existence of which is a basic assumption on which the contract is made, no duty to render that performance arises, unless the language or circumstances indicate the contrary.

However, claiming impracticability would have afforded Mr. Leonard no relief. The RESTATEMENT draws an illustration from *Stees v. Leonard*:

A contracts with B to build a house on B's land according to plans furnished by A. Because of subsoil conditions, of which A has no reason to know, this cannot be done unless the land is drained at great expense. After the house is partly completed, it collapses because of these conditions, and A refuses to continue the work. The court may determine from all the circumstances, including the fact that A furnished the plans, that A is under a duty to build the house in spite of the impracticability of doing so, and that A is liable to B for breach of contract.

Id. § 266 cmt. b, illus. 8. *See generally* John Eloffson, *The Dilemma of Changed Circumstances in Contract Law: An Economic Analysis of the Foreseeability and Superior Risk Bearer Tests*, 30 COLUM. J.L. & SOC. PROBS. 1 (1996) (endorsing a foreseeability approach in determining whether a changed circumstance is impracticable or an allocated risk).

23. *See* CHARLES FRIED, *CONTRACT AS PROMISE: A THEORY OF CONTRACTUAL OBLIGATION* 64 (1981) (citing *Stees v. Leonard*, 20 Minn. 494 (1874) (holding that the builder's performance was

The common law rule recognizes that the parties bargained for a fixed price and an unwavering promise to live up to their words. The message of the common law rule is clear: promises must be kept. The common law forces the contractor to perform or pay damages even in the face of extreme hardship.

B. The Pre-Existing Duty Rule and Contract Modification: Failing to Accommodate Changed Circumstances

In addition to the common law rule allocating the risk of unforeseen conditions to the contractor, a second rule also favors the owner over the contractor when a differing site condition is discovered. The common law's pre-existing duty rule precludes even a voluntary modification of a construction contract by an owner and contractor to account for unforeseen conditions. The pre-existing duty rule's more modern form, under the *Restatement (Second) of Contracts*, now permits such modifications under certain circumstances. Thus, in its current form, the pre-existing duty rule has lost its sharp edge, but it still affords protection to an owner from coercive demands by a contractor to modify the contract due to unforeseen conditions.²⁴ In the case of differing site conditions,

not excused and granting judgment in favor of the owner; however, the award was limited to the return of progress payments)); see also GRANT GILMORE, *DEATH OF CONTRACT* 77-78 (1974). As one court explained,

It is conceded that, under the common-law rule, a contractor who undertakes an entire contract for erecting a building is presumed, in absence of an expressed provision to the contrary, to have assumed the risk of unforeseen contingencies arising during the course of the work, unless performance is rendered impossible by the act of God, the law or the other party.

David J. Hatem, *Differing Site Conditions: Liability Precautions for Design Professionals*, 61 DEF. COUNS. J. 565, 566 (1994) (quoting *Eastern Tunneling Corp. v. Southgate Sanitation Dist.*, 487 F. Supp. 109, 113 (D. Colo. 1979)); see also *Ruby-Collins, Inc. v. City of Charlotte*, 740 F. Supp. 1159, 1173 (W.D.N.C. 1990) (holding that the contractor may not recover additional costs, in absence of differing site condition clause, when excavated soil was not suitable for backfill), *aff'd*, 930 F.2d 23 (4th Cir. 1991); *American Demolition, Inc. v. Hapeville Hotel Ltd. Partnership*, 413 S.E.2d 749, 752 (Ga. Ct. App. 1991) (holding that the risk of extra expense associated with subsurface conditions is on the contractor absent a changed condition clause).

24. The rule is often condemned. See Kevin M. Teeven, *Development of Reform of the Preexisting Duty Rule and its Persistent Survival*, 47 ALA. L. REV. 387, 387 (1996) ("The tenacious 400-year survival of the much-criticized preexisting duty rule reflects the impregnability of the common law of contract's core doctrinal fortress of consideration."); Mark B. Wessman, *Retraining the Gatekeeper: Further Reflections on the Doctrine of Consideration*, 29 LOY. L.A. L. REV. 713, 729-30 ("Of all the purported corollaries to the doctrine of consideration, the pre-existing duty rule has probably received the harshest treatment at the hands of the critics. It appears to have no current academic advocates . . . [It] is, nevertheless, one of the most durable of the corollaries to the doctrine of consideration . . ."). This Article takes no position as to its viability. It merely questions why, given its existence, owners voluntarily surrendered the benefits received through its

the pre-existing duty rule protects the owner from a contractor's demands for modification of the contract following discovery of an unforeseen condition creating additional work during performance of the contract.²⁵

The pre-existing duty rule is grounded in two important contract principles. First, it is consistent doctrinally with the fundamental contract principle that promises must be supported by consideration to be enforceable.²⁶ Second, the pre-existing duty rule protects and supports the contract principle that promises must be given with free will and without coercion.²⁷ Both principles are equally at stake when applied to construction contract modifications. The rule protects the consideration principle because the rule protects the value of the original bargain.²⁸ In a fixed-fee contract, an owner originally bargained for a fixed price for completion of a project and an owner stands to lose the benefit of that bargain by a mid-performance modification of the price. Without new consideration, the full benefit of the initial bargain would be diminished.²⁹ Moreover, during the performance, the owner is typically at a bargaining disadvantage because the owner cannot effectively counter the contractor's threat to abandon the project unless the contractor receives additional payment. The contractor that threatens to quit the contract has already determined that abandonment and breach of the contract is an economically more favorable risk than continued performance. Thus, an owner has little to withhold in bargaining for a demanded modification.

application, in the event of differing site conditions.

25. See Wessman, *supra* note 24, at 749-50 (describing the application of the pre-existing duty rule in construction cases).

26. See Subha Narasimhan, *Of Expectations, Incomplete Contracting, and the Bargain Principle*, 74 CAL. L. REV. 1123, 1184 (1986) (stating that the pre-existing duty rule is "consistent with the underlying premise of complete risk allocation"). But see Teeven, *supra* note 24, at 468-69 (stating that the pre-existing duty rule is not well-grounded in the consideration doctrine).

27. See Teeven, *supra* note 24, at 469-70; see also Richard Nathan, *Grappling with the Pre-Existing Duty Rule: A Proposal for a Statutory Amendment*, 23 AM. BUS. L.J. 509, 511 (1986) (citing 1A A. CORBIN, CORBIN ON CONTRACTS § 183 (1963); 1 S. WILLISTON, A TREATISE ON THE LAW OF CONTRACTS § 130 (3d ed. 1957)).

28. But see Teeven, *supra* note 24, at 399-406 (arguing that modifications should be permissible without consideration and that the pre-existing duty rule is not doctrinally supported by consideration analysis nor fairly justified where other judicial doctrines can protect against coercive demands).

29. But see Wessman, *supra* note 24, at 743-44 (suggesting that the pre-existing duty rule has no consideration rationale).

Even if it is assumed that only promises that are components of bargained exchanges should be enforced, an adjustment to only one side of a bargained exchange does not transform the entire exchange transaction into a gift transaction. . . . Nothing in the very notion of consideration, however, logically compels that modifications be treated like initial contract formation or that parties who have agreed on the terms of a proposed exchange may not revisit and revalue it if they choose.

Id.

The pre-existing duty rule protects the owner from coercive demands while in this weakened position.³⁰

An early classic construction case demonstrates the operation of the pre-existing duty rule and its benefit to the owner. In *Lingenfelder v. Wainwright Brewery Co.*,³¹ an architect who was hired to draft plans and oversee the erection of a brewery threatened to stop work without additional payment for the previously promised services.³² The court rejected the mid-performance modification, explaining:

"That a promise to pay a man for doing that which he is already under contract to do is without consideration" is conceded by respondents. The rule has been so long imbedded in the common law and decisions of the highest courts of the various states that nothing but the most cogent reasons ought to shake it. . . .

. . . Nothing we have said is intended as denying parties the right to modify their contracts, or make new contracts, upon new or different considerations, and binding themselves thereby. What we hold is that, when a party merely does what he has already obligated himself to do, he cannot demand an additional compensation therefor, and although by taking advantage of the necessities of his adversary he obtains a promise for more, the law will regard it as *nudum pactum*, and will not lend its process to aid in the wrong.³³

In *Lingenfelder*, the court desired to protect the original consideration and prevent coercive modifications. Defendant Wainwright Brewery had bargained to pay a fixed amount in consideration for the architect's services and stood to lose the benefit of that bargain by giving a new promise without new consideration from the architect. Moreover, the mid-performance timing of the proposed contract modification placed the brewery at a bargaining disadvantage.

30. See *City of Miami Beach v. Fryd Constr. Corp.*, 264 So. 2d 13, 15 (Fla. Dist. Ct. App. 1972).

While the general rule [the pre-existing duty rule] has been criticized and exceptions created, one justification for its continued existence is that a contractor may purposely submit a low bid in order to secure the contract, but then refuse to perform, after it is too late to obtain another contractor without loss or inconvenience, in order to induce a promise to pay more.

Id.

31. 15 S.W. 844 (Mo. 1891).

32. See *id.* at 844.

33. *Id.* at 848. The most notable case articulating the pre-existing duty rule's protection from coercion, *Alaska Packers' Ass'n v. Domenico*, 117 F. 99 (9th Cir. 1902), demonstrated that mid-way through any contract, one party may be disadvantaged and vulnerable to abusive bargaining. See *id.* at 102. In *Alaska Packers'*, sailors and fishermen promised to work a short fishing season in Alaska. See *id.* at 100. The fishermen refused to complete their promised work absent a contract modification for more payment because the fishing nets were allegedly defective. See *id.* at 101. Although Alaska Packers' Association acceded to the demands of the sailors and fishermen, the appellate court declined to enforce the modification, clearly believing the fishermen and sailors had taken advantage of Alaska Packers' geographic isolation and inability to recruit new workers for such a short season or to recoup the considerable loss from a work stoppage. See *id.* at 102.

The pre-existing duty rule, when rigidly applied, also leads to seemingly unfair results.³⁴ Some modifications are reached without apparent coercion, and the consideration for the modified bargain represents a fairer transaction than the initial bargain. In that instance, the modification actually prevents unjust enrichment of the promisor.³⁵ Judicial discomfort with the pre-existing duty rule grew as courts recognized that some modifications should be enforced despite the absence of consideration.³⁶ A softening of the rule gained judicial approval and is reflected in the *Restatement (Second) of Contracts*.³⁷

The modern pre-existing duty rule now charts a middle ground, protecting both consideration and free will while softening the harsh results of the pre-existing duty rule in certain cases. In order to protect the value of the original consideration, a modification must now be "fair and equitable" in view of unanticipated circumstances.³⁸ Thus, the modification can be viewed as representing, at least partially, new and previously unbargained for performance. Moreover, as the *Restatement's* commentary explains, "fair and equitable" also speaks to the "absence of coercion," and the phrase cautions the trier of fact to assess "the relative financial strength of the parties . . . to show or negate imposition or unfair surprise."³⁹

34. See generally Teeven, *supra* note 24 (discussing history of pre-existing duty rule).

35. Massachusetts case law permits a court to find consideration in a promise to perform what one is already bound to perform because the new promise is given in lieu of an action for damages to secure performance. See *Swartz v. Lieberman*, 80 N.E.2d 5, 6 (Mass. 1948) (citing *Munroe v. Perkins*, 26 Mass. (9 Pick.) 298 (1830)). But see JOHN D. CALAMARI & JOSEPH M. PERILLO, *CONTRACTS* § 4-8 (2d ed. 1977) (criticizing the Massachusetts rule).

36. See *Nathan*, *supra* note 27, at 511 ("The pre-existing duty rule became the subject of growing judicial hostility because it irrationally prevented intentional agreements from being enforced. Through a technical and often confused redefinition of consideration or the legal fiction of rescission, courts attempted to escape from this perceived legal straitjacket.").

The *Uniform Commercial Code* freely permits mid-performance modifications without new consideration. See U.C.C. § 2-209 (1981). However, it requires that all such modifications meet the test of good faith and legitimate commercial reason. See *id.* § 2-209 cmt. 1; see also J. WHITE & R. SUMMERS, *UNIFORM COMMERCIAL CODE* § 1-6, at 44 n.26 (4th ed. 1995) (citing Robert A. Hillman, *Policing Contract Modifications Under the UCC: Good Faith and the Doctrine of Economic Duress*, 64 IOWA L. REV. 849 (1979)).

37. RESTATEMENT (SECOND) OF CONTRACTS § 89(a) (1981) permits modification of a "contract not fully performed on either side . . . if the modification is fair and equitable in view of circumstances not anticipated by the parties when the contract was made"

38. See *id.*

39. *Id.* § 89 cmt. b. *Angel v. Murray*, 322 A.2d 630 (R.I. 1974), demonstrates application of the *Restatement* rule. *Id.* at 636. In *Angel*, a trash collector operated a trash business in Newport according to a series of five-year fixed-price contracts. See *id.* at 632. Unexpectedly, in the 1960s, the town enjoyed tremendous growth. See *id.* While in prior years, fewer than 25 homes were added to the trash collector's route, suddenly the city grew by 400 homes in 1967. See *id.* The town willingly agreed to modify the contract, but a disgruntled taxpayer filed suit. See *id.* Why would

Nowhere is it more likely that contracting parties will encounter differing and unforeseen conditions than on construction projects. While contractors and owners hope that in pricing a project they can anticipate what they will encounter under the land or otherwise hidden from view, clearly they cannot predict this with certainty. Under the common law, the fixed-price construction contract assigns the risk of unknown conditions to the contractor. The contractor, through experience or careful bid preparation and site inspection, is expected to bid an amount sufficient to cover even the unexpected. However, the modern common law contract modification rules recognize that contract plans sometimes go awry. The modern rule permits flexibility during the performance of construction contracts by permitting modifications based upon unforeseen conditions. At the same time, the modern rule protects the initial bargain against the potential coercion and duress of mid-performance modifications by requiring fair and equitable terms and methods of bargaining.⁴⁰

Without surrendering judicial authority to police the contracting process, the common law now permits some of the flexibility that modern contract relationships demand. In the context of construction contracts governed by the common law, the owner continues to enjoy an advantage. The owner may agree voluntarily to a modification for unforeseen conditions; however, the owner is under no obligation to modify the contract because the law continues to allocate the risk of unforeseen conditions to the contractor.⁴¹ The common law permits the owner to enjoy the benefit of a contractor's failure to anticipate the actual conditions or to bid a sufficient contingency and holds the contractor to its promise regardless of the hardship.

Newport agree to do what it had no obligation to do, namely, pay additional amounts? The long-term relationship, the fact that the trash collector would build larger contingencies into later contracts, the fear of breach (no politician wants trash on the street), and fundamental fairness are possible motives. Clearly the town valued the continuing relationship. The court upheld the modification, relying on the *Restatement*, and found the modification voluntary, fair, and equitable. *See id.* at 635-38.

40. *See, e.g.,* Brian Constr. & Dev. Co. v. Brighenti, 405 A.2d 72, 75-76 (Conn. 1978) (holding that an oral agreement to modify a construction contract is supported by additional consideration when unanticipated and burdensome conditions were encountered and modification is fair and equitable).

41. *Cf. Watkins & Son, Inc. v. Carrig*, 21 A.2d 591, 594 (N.H. 1941) (permitting oral agreement to supersede prior contract when unexpected rock was encountered during excavation of cellar).

III. DIFFERING SITE CONDITIONS CLAUSES: ALTERING COMMON LAW PRINCIPLES

A. *Requiring Contract Modification and Reallocating Risks*

A contract provision now almost uniformly appearing in fixed-fee construction contracts dramatically changes the common law. The differing site condition or changed condition provisions that the American Institute of Architects (AIA),⁴² the Federal Acquisition Regulations (FAR),⁴³ and the Engineers' Joint Contract Documents Committee

42. AMERICAN INSTITUTE OF ARCHITECTS, *General Conditions of the Contract for Construction*, AIA DOCUMENT A201 § 4.3.6 (11th ed. 1987) [hereinafter AIA DOCUMENT A201]:

Claims for Concealed or Unknown Conditions. If conditions are encountered at the site which are (1) subsurface or otherwise concealed physical conditions which differ materially from those indicated in the Contract Documents or (2) unknown physical conditions of an unusual nature, which differ materially from those ordinarily found to exist and generally recognized as inherent in construction activities of the character provided for in the Contract Documents, then notice by the observing party shall be given to the other party promptly before conditions are disturbed and in no event later than 21 days after first observance of the conditions. The Architect will promptly investigate such conditions and, if they differ materially and cause an increase or decrease in the Contractor's cost of, or time required for, performance of any part of the Work, will recommend an equitable adjustment in the Contract Sum or Contract Time, or both. If the Architect determines that the conditions at the site are not materially different from those indicated in the Contract Documents and that no change in the terms of the Contract is justified, the Architect shall so notify the Owner and Contractor in writing, stating the reasons. Claims by either party in opposition to such determination must be made within 21 days after the Architect has given notice of the decision. If the Owner and Contractor cannot agree on an adjustment in the Contract Sum or Contract Time, the adjustment shall be referred to the Architect for initial determination, subject to further proceedings pursuant to Paragraph 4.4.

43. Federal Acquisition Regulations, 48 C.F.R. § 52.236-2 (1996) (discussing differing site conditions):

(a) The Contractor shall promptly, and before the conditions are disturbed, give a written notice to the Contracting Officer of (1) subsurface or latent physical conditions at the site which differ materially from those indicated in this contract, or (2) unknown physical conditions at the site, of an unusual nature, which differ materially from those ordinarily encountered and generally recognized as inhering in work of the character provided for in the contract.

(b) The Contracting Officer shall investigate the site conditions promptly after receiving the notice. If the conditions do materially so differ and cause an increase or decrease in the Contractor's cost of, or the time required for, performing any part of the work under this contract, whether or not changed as a result of the conditions, an equitable adjustment shall be made under this clause and the contract modified in writing accordingly.

(c) No request by the Contractor for an equitable adjustment to the contract under this clause shall be allowed, unless the Contractor has given the written notice required; *provided*, that the time prescribed in (a) above for giving written notice may be extended

(EJCDC)⁴⁴ adopted abrogate the two common law rules that protected the owner from a demanded modification for unforeseen conditions during performance of a construction contract. First, contrary to the common law, the clause allocates risks of subsurface or latent conditions to the owner under certain conditions.⁴⁵ Moreover, these provisions obligate the parties to modify their contract and to reach a new agreement when a differing site condition is discovered during performance.⁴⁶

*Servidone Construction Corp. v. United States*⁴⁷ demonstrates how the differing site condition alters the common law. The United States contracted with Servidone, the second lowest bidder, to build an earthen dam and lake.⁴⁸ Servidone's bid of approximately \$25 million was about \$3 million less than the government's initial estimate (excluding profit)

by the Contracting Officer.

(d) No request by the Contractor for an equitable adjustment to the contract for differing site conditions shall be allowed if made after final payment under this contract.

44. The Engineers' Joint Contract Documents Committee's Differing Site Conditions provision distinguishes between physical conditions and underground facilities. As to the former:

4.2.5. *Possible Document Change*: If ENGINEER concludes that there is a material error in the Contract Documents or that because of newly discovered conditions a change in the Contract Documents is required, a Work Directive Change or a Change Order will be issued as provided in Article 10 to reflect and document the consequences of the inaccuracy or difference.

4.2.6. *Possible Price and Time Adjustments*: In each such case, an increase or decrease in the Contract Price or an extension or shortening of the Contract Time, or any combination thereof, will be allowable to the extent that they are attributable to any such inaccuracy or difference. If OWNER and CONTRACTOR are unable to agree as to the amount or length thereof, a claim may be made therefor as provided in Articles 11 and 12.

ENGINEERS' JOINT CONTRACT DOCUMENTS COMMITTEE, STANDARD GENERAL CONDITIONS OF THE CONSTRUCTION CONTRACT §§ 4.2.5-4.2.6, at 11 (1983) [hereinafter EJCDC].

In the EJCDC, underground facilities are defined, in part, as "pipelines, conduits, ducts, cables, wires, manholes, vaults, tanks, tunnels or other such facilities or attachments." *Id.* at 8. The General Conditions also permit recovery by the contractor. When the contractor discovers an underground facility "which was not shown or indicated in the Contract Documents and which [the contractor] could not reasonably have been expected to be aware of . . . [the contractor] shall be allowed an increase in the Contract Price or an extension of the Contract Time" to the extent attributable to the changed conditions. *Id.* § 4.3.2., at 11.

45. See 48 C.F.R. § 52.236-2 (discussing the allocation of risks to the government); AIA DOCUMENT A201, *supra* note 42, § 4.3.6 (allocating risk of concealed or unknown conditions to owners); EJCDC, *supra* note 44, § 8.6 (stating that the owner "is obligated to execute Change Orders").

46. See 48 C.F.R. § 52.236-2(b) (stating that "an equitable adjustment shall be made"); AIA DOCUMENT A201, *supra* note 42, § 4.3.6 (stating that "equitable adjustment in the Contract Sum or Contract Time, or both" will be made); EJCDC, *supra* note 44, § 4.2.5 (stating that "a Work Directive Change or a Change Order will be issued").

47. 19 Cl. Ct. 346 (1990), *aff'd*, 931 F.2d 860 (Fed. Cir. 1991).

48. See *id.* at 349.

of \$28 million for the project.⁴⁹ Servidone "encountered numerous problems during construction of the dam that more than doubled its anticipated cost"⁵⁰ chiefly because "the soil was so difficult to excavate, unload, and process that many additional and more powerful pieces of equipment were required."⁵¹ Servidone claimed that the adverse soil conditions were a differing site condition, of either a Type I or Type II nature,⁵² and that it was entitled to an equitable adjustment of the contract.⁵³

The court first reviewed whether the discovered soil condition constituted a Type I differing site condition. In order to prove a Type I condition, a contractor must show that "it encountered subsurface or latent physical conditions at the site that differed materially from those

49. *See id.*

50. *Id.* at 355.

51. *Id.*

52. The federal clause shifts two kinds of risk to the owner. When documents affirmatively describe subsurface conditions that are different than those actually encountered, a Type I claim arises, requiring:

(i) the contract documents must have affirmatively indicated or represented the subsurface conditions which form the basis of the plaintiff's claims; (ii) the contractor must have acted as a reasonably prudent contractor in interpreting the contract documents; (iii) the contractor must have *reasonably* relied on the indications of subsurface conditions in the contract; (iv) the subsurface conditions actually encountered, within the contract site area, must have differed *materially* from the subsurface conditions indicated in the same contract area; (v) the actual subsurface conditions encountered must have been reasonably unforeseeable; and (vi) the contractor's claimed excess costs must be shown to be solely attributable to the materially different subsurface conditions within the contract site.

Youngdale & Sons Constr. Co. v. United States, 27 Fed. Cl. 516, 528 (1993); *see P.J. Maffei Bldg. Wrecking Corp. v. United States*, 3 Cl. Ct. 482, 484 (1983) (Documents refers not just to bidding documents but also to other documents referred to, or furnished to, bidders; "all that is required is that there be enough of an indication on the face of the contract documents for a bidder reasonably not to expect subsurface or latent physical conditions."), *aff'd on other grounds*, 732 F.2d 913 (Fed. Cir. 1984); *see also* JUSTIN SWEET, SWEET ON CONSTRUCTION INDUSTRY CONTRACTS: MAJOR AIA DOCUMENTS § 14.6, at 48 (Supp. 1988) ("Cases have given broad interpretation to this clause, the indications giving rise to owner liability may merely have been a description of the project, or information from which a reasonable contractor might 'infer' that the conditions would not be the conditions encountered.").

A Type II claim is one in which the risk of the subsurface conditions was unknown to both parties and not described within the contract documents: "Generally, the conditions must be unknown, unusual, and differ materially from what is ordinarily encountered. The difference then, is between what is ordinarily expected to be found and that which actually is found." Gregory H. McClure, *Differing Site Conditions: Evaluating the Material Difference*, 15 PUB. CONT. L.J. 138, 162 (1984); *see also Youngdale*, 27 Fed. Cl. at 528 (describing differences between Type I and Type II claims); George Edson Mason, A Quantitative Risk Management Approach to the Selection of Construction Contract Provisions 56 (1973) (Ph.D. dissertation, Stanford University), *microformed on* Technical Report No. 173 (Univ. Microfilms Int'l) (stating that an owner may retain risk of differing site conditions by the use of a changed condition or differing site conditions clause).

53. *See Servidone*, 19 Cl. Ct. at 355-56.

expressly or impliedly indicated in the contract.”⁵⁴ Servidone claimed that the soil was wetter than indicated in the contract documents, and that the government’s use of a “liquid limit correlation curve” (LLCC) led Servidone to mistakenly assume that “optimum moisture was also at its optimum point of workability, and that no further moisture change would be required.”⁵⁵ As to the moisture content claim, the court found the variation from the plans and the conditions encountered were not legally significant.⁵⁶ As to the LLCC, the court concluded that the curve provided accurate information, but that “Servidone’s real problem [was] that its personnel did not understand the LLCC.”⁵⁷ The court denied Servidone’s Type I claims and concluded it “was less than reasonable for [Servidone’s] personnel to make assumptions about how the curve worked in preparing the bid.”⁵⁸

Servidone also alleged that the conditions encountered constituted a Type II differing site condition.⁵⁹ To prove a Type II condition, the contractor must show that “it encountered an ‘unknown physical [condition] at the site, of an unusual nature, differing materially from those ordinarily encountered and generally recognized as inhering in the work of the character provided for in this contract.’”⁶⁰ Servidone complained that the fill material was “extremely tough” and that “this toughness

54. *Id.* at 356; see also *Youngdale & Sons Constr. Co. v. United States*, 27 Fed. Cl. 516, 530 (1993) (stating that to prove a Type I condition, “plaintiff must prove that the government affirmatively indicated or represented the subsurface conditions on which the basis of plaintiff’s claim is formed”).

A Type I claim, unlike common law negligence or misrepresentation, requires no culpability. As one court explained,

In misrepresentation, the wrong consists of misleading the contractor by a knowingly or negligently untrue representation Some degree of Government culpability—either untruth or such error as is the legal equivalent—must, however, be shown, and the plaintiff’s burden of proof is not satisfied merely by proof of a variation between the subsurface conditions as stated in the contract and as encountered.

. . . In the modern version of the [differing site condition] clause, “. . . a finding that the contractor was actively ‘misled,’ in the sense that the Government ‘withheld’ or ‘concealed’ information within its grasp, is not essential to proof of a changed condition.

. . . Fault on the part of the Government is not a necessary element.”

Foster Constr. C.A. & Williams Bros. Co. v. United States, 435 F.2d 873, 880-81 (Ct. Cl. 1970) (quoting *United Contractors v. United States*, 368 F.2d 585, 597 n.6 (Ct. Cl. 1966)).

55. *Servidone*, 19 Cl. Ct. at 357.

56. See *id.* at 356-57 (stating that the “maximum variation of approximately 3 percentage points in moisture contents cited by Servidone is less than one fifth of the 17-point range of moisture contents suggested by the boring logs” and the average was “near the range of moisture required by the most demanding requirements in the contract”).

57. *Id.* at 359.

58. *Id.*; see also *Youngdale*, 27 Fed. Cl. at 533 (discussing a “reasonably prudent contractor” preparing a bid).

59. See *Servidone*, 19 Cl. Ct. at 360.

60. *Id.* at 360 (alteration in original).

added dramatically to the cost of completion.”⁶¹ The United States, on the other hand, defended against the claim by asserting the conditions were typical of the Dallas/Fort Worth area where the work was taking place.⁶² Evidence showed that the soil “behav[ed] like paraffin or grease” and was “slick and sticky.”⁶³ Servidone’s experts testified that the clay was unlike any encountered elsewhere in Dallas/Fort Worth.⁶⁴ Even the government’s experts, who testified they had encountered such clay before in the area, admitted that the soil’s toughness yielded smaller payloads than they experienced in nearby projects.⁶⁵ The clay also caused machinery to get stuck and was more difficult to unload than ordinarily expected.⁶⁶ Moreover, the contractor was forced to use additional and more powerful machinery to plow and haul the clay.⁶⁷ The clay also caused “more frequent mechanical breakdowns.”⁶⁸ The court rejected the government’s position that the soil was not materially different than ordinarily found, and concluded that the evidence showed “the materials at [the project site] were unusual and differed materially not only from other soils generally, but also with respect to soils generally encountered in the Dallas/Ft. Worth area.”⁶⁹

Servidone also had to establish that the condition was unknown to it and should not have reasonably been anticipated at the time of bidding in order to prevail on the Type II claim.⁷⁰ The question required the court to examine Servidone’s knowledge and conduct during the pre-bid phase. The court’s holding is surprising in light of its finding that Servidone acted unreasonably in preparing its bid by conducting an inadequate site inspection, by failing to inform itself about “local

61. *Id.*

62. *See id.*

63. *Id.* at 360-61.

64. *See id.*

65. *See id.* at 362.

66. *See id.* at 363.

67. *See id.* at 365.

68. *See id.*

69. *Id.* at 370.

70. *See id.* at 371. In *Youngdale*, the court explained:

The well-established principle is true that a contractor is not required “to discover *hidden* subsurface conditions or those beyond the limits of an inspection appropriate to the time available.” Moreover, the court is also mindful of the fact that a contractor is not charged with the technical intellect or grasp of a geologist or other expert. On the other hand, the court also notes that a contractor is deemed to be on notice of any subsurface conditions *indicated*, as here, within the boring logs of the contract documents, and, to the extent that a contractor must interpret said logs, a contractor is to be held to the standard of a reasonably prudent contractor in deciphering the meaning of such logs.

Youngdale & Sons Constr. Co. v. United States, 27 Fed. Cl. 516, 533-34 (1993) (citations omitted).

anomalies," and by failing to learn about "the significance of the LLCC."⁷¹

The court finds that Servidone did not act reasonably in preparing its bid. The relevant inquiry, however, is how greater caution should have been reflected in Servidone's bid. . . . The standard of reasonable anticipation does not require a contractor to expect the worst Indeed this would be contrary to the purpose of the differing site condition clause. . . .

. . . .
In sum, even a reasonable contractor, having done an adequate site inspection, and having general knowledge about the difficulty of high LL soils, would not have been warned about the actual condition of these soils. The court thus holds that Servidone is entitled to recover to the extent the condition it encountered could not have been reasonably anticipated. . . . While the plaintiff acted unreasonably in preparing its bid, it would constitute a windfall to defendant to hold that fact precluded a finding of a differing site condition in these circumstances.⁷²

Servidone demonstrates the dramatic change in outcome when a differing site condition provision is added to the contract. With the provision, the contractor continues to bear the common law risk of the usual and expected conditions at a construction site; however, the contractor no longer must gamble that the unexpected might occur. Unlike Mr. Leonard, who bore the risk and expense of extra work engendered by latent soil conditions on Mr. Stees' property,⁷³ Servidone successfully forced the government owner to adjust the contract and bear the risk of the unusual, latent soil conditions.⁷⁴ Importantly, the court in *Servidone* acknowledged that to hold otherwise, even in light of Servidone's imprudence, would result in an unfair "windfall" to the government owner.⁷⁵ The windfall the court would not countenance was only a windfall because the differing site condition provision substitutes a promise of a fair price for the common law promise of a fixed price as part of the original bargain. The differing site condition provision no longer permits the owner to reap an unexpected windfall by paying less than a fair price for work actually done. On the other hand, the provision permits a contractor to win what is called a fixed-price contract without the promise to complete the work for a fixed sum.

71. See *Servidone*, 19 Cl. Ct. at 373.

72. *Id.* at 374-75 (citations omitted). The court found Servidone made minimal inquiry into site conditions despite its lack of experience in Texas and was imprudent in failing to inform itself about the effect of the LLCC. See *id.* at 373.

73. See *supra* text accompanying notes 11-21.

74. See *Servidone*, 19 Cl. Ct. at 383-90.

75. See *id.* at 375.

B. Justifications for Including Differing Site Condition Provisions

As weary taxpayers wonder why government projects have run over budget,⁷⁶ one questions why public property owners willingly adopted contracting rules that reallocated the risk of unforeseen subsurface and latent conditions to owners.⁷⁷ The practice is more questionable considering that the modern common law permitted the owner the flexibility to freely modify contracts as desired and to freely reject modifications and hold contractors to their original promises. Certainly, the inclusion of the clause and the resulting increase in actual performance costs as opposed to the contract's bid price undermines public confidence in whether government contracting procedures are fair to taxpayers. Public support

76. See *supra* notes 1-5; see also *P.T. & L. Constr. Co. v. New Jersey Dep't of Transp.*, 531 A.2d 1330, 1341 (N.J. 1987) ("As we know, in the long run, it is the public that pays for these cost over-runs. . . . Courts must weigh the unknown economic consequences . . .").

The public often questions why fixed price construction contract costs soar beyond the bottom line. See, e.g., Ingrid Martin, *Contractors Continue Work on Native Medical Center*, 20 ALASKA J. COM. 9, 9 (January 15, 1996) (discussing unanticipated ground water increasing project costs); Leslie Haggin, *\$27M Public Project Delayed: Is Garage Site a Danger? Contractors Cite Chemical Drums*, RECORD (Northern New Jersey), Sept. 15, 1995, at A1 (recounting cost impact of discovery of hazardous materials); Jon D. Markman, *No Light at End of the Tunnel*, L.A. TIMES, Dec. 21, 1995, at B1 (recounting tunneling contractor's difficulties with differing site conditions); Gordon Oliver, *Tri-Met Stuck in Tunnel Muck*, PORTLAND OREGONIAN, Jan. 5, 1995, at A-1 ("[F]ailure to predict the underground conditions [loose rock] is a key factor in generating the extra costs that now plague the project. The contract, like most major construction contracts, makes the owner . . . responsible for unexpected, or changed conditions."); Andrew Taylor, *Road Costs 'Overrun by 27%*, FIN. TIMES, May 27, 1994, at 10 (discussing a study that found an average of 27% overruns on public roadwork and that "claims for extra payments from contractors, mainly to cover unforeseen ground conditions, were the biggest cause of overruns").

77. Not all risk is shifted by the provision. The conditions must differ "materially." See McClure, *supra* note 52, at 142. In a Type I claim, materiality is measured by the materiality of the difference between the contract documents and the actual conditions. See *id.* at 145. In a Type II claim, materiality is measured by the conditions known as usual and ordinary in that geographical area when performing the kind of work to be done. See *id.* at 161-62.

Recovery has been allowed for unexpected natural conditions, subsurface conditions, man-made conditions, and even equipment failure. See *Shank-Artukovich v. United States*, 13 Cl. Ct. 346 (1987), (recovery for "running ground" condition in tunnel excavation), *aff'd*, 848 F.2d 1245 (Fed. Cir. 1988); *Morrison-Knudsen Co. v. United States*, 345 F.2d 535, 544 (Cl. Ct. 1965) (recovery for permafrost); *W.S. Meadows Eng'g, Inc.*, 88-2 B.C.A. (CCH) ¶ 20,616 (1988) (recovery for unforeseen cost of air quality testing); *Edgar M. Williams, General Contractor*, 72-2 B.C.A. (CCH) ¶ 9734 (1972) (recovery for encountering double roof instead of industry standard of single roof).

On the other hand, contractors bear the risk of weather, changes in the economy, foreseeable overruns, and unavailability of materials or supplies. See *Associated Eng'rs & Contractors v. Hawaii*, 567 P.2d 397, 403 (Haw. 1977) (bad weather atop Mauna Kea); see also *Rolin v. United States*, 160 F. Supp. 264, 268 (Cl. Ct. 1958) ("[T]he fact that a person who has contracted with the Government to furnish materials or services encounters unforeseen difficulties, and thereby incurs unexpected expenses, in the performance of the contract does not impose upon the Government any legal obligation to relieve its contractor of the unexpected financial burden.").

for public works and capital improvements wanes as the price escalates over the expected costs.

The decision to reallocate risks in federal and standard form contracts from the common law outcome represents a decades-long dialogue among large private⁷⁸ and public owners, engineers, contractors, architects, and designers concerning values and morality, survival and protection of industries, and analysis of which party can better bear the risk of unforeseen conditions while ensuring that projects continue to their completion.⁷⁹ Both economic and normative justifications exist for altering the common law when contractors and large owners engage in continuing business relations via a bid process.

1. Economic Justifications

a. The Reallocation of Risk to the Owner: Designed to Ensure Fair Bids

The primary purpose of differing site condition clauses within construction contracts is to encourage contract bidders to submit their lowest bids rather than build cushions into their bids for contingencies that may never occur.⁸⁰ As one court explained,

78. Justin Sweet complains that the participation of private owners in drafting the AIA clauses is far less than perceived:

Another reason for AIA domination is the commonly held belief that the documents reflect consensus as to the needs of construction industry participants and that the documents follow the customary practices of that industry. As I have noted, however, the claim of industry consensus is increasingly being questioned, the principal challenge being based upon the lack of owner participation.

Justin Sweet, *The American Institute of Architects: Dominant Actor in the Construction Documents Market*, 1991 WIS. L. REV. 317, 324 [hereinafter Sweet, *Dominant Actor*].

79. See *Foster Constr. C.A. & Williams Bros. Co. v. United States*, 435 F.2d 873, 887 (Ct. Cl. 1970) (discussing "long-standing, deliberately adopted procurement policy, expressed in the standard mandatory changed conditions clause"); Sweet, *Dominant Actor*, *supra* note 78, at 322 (describing collaborative process in developing AIA construction contract forms); see also Dale R. Ellickson, *Contracting Principles for Construction Contracts*, in CONSTRUCTION CONTRACT DOCUMENTS, at 1, 2 (1990) (A.B.A. Section of Public Contract Law Conference Papers) (discussing the inclusive AIA process and stating that "in order for standard forms to meet the goal of achieving a 'wise agreement,' all parties must believe that their interests have been fairly considered"). See generally CONSTRUCTION RISKS AND LIABILITY SHARING (1979) (conference co-sponsored by National Academy of Engineering, American Bar Association, Department of the Army, U.S. Department of Energy, U.S. Environmental Protection Agency, U.S. Department of the Interior, U.S. Department of Transportation) [hereinafter CONSTRUCTION RISKS].

80. See *Youngdale*, 27 Fed. Cl. at 527 (1993) ("Therefore, to avoid any 'padding' of the contract price by the contractors and to, at the very least, remove some of the gamble of bidding, the government has provided the Differing Site Conditions clause . . . as an ameliorating factor."); see also *Foster*, 435 F.2d at 887 ("The Government benefits from more accurate bidding, without

"Padding" of the contract may occur when the *contractor* attempts to allocate some of the risk for delays or increases in costs of performance due to any latent or subsurface conditions discovered during performance of the contract which were generally not accounted for in the original bid estimate. As a result, such contingency bidding by the contractor works against the government, in that it is unable to obtain the best possible price for the construction project.⁸¹

Government analysts and researchers assert that in the "aggregate" the risk allocation saves the owner money:

In theory, this equitable apportionment should minimize costs to the owner because it allows the contractor to remove this contingency from the bid. The owner avoids overpayment on the majority of projects and is required to pay for differing site conditions only when they occur. Utility theory predicts that costs rise when risk is inappropriately allocated, and preliminary studies by the United States Corp of Engineers indicate, in the aggregate, that differing site conditions clauses do reduce the cost of construction.⁸²

In the aggregate, including the differing site condition provision in the contract means contractors will bid accurately,⁸³ without fear of the burden of changed conditions, and owners will pay for the work actually done and not more.⁸⁴ Thus, for public and private entities soliciting bids

inflation for risks which may not eventuate."); *Municipality of Anchorage v. Frank Coluccio Constr. Co.*, 826 P.2d 316, 318 (Alaska 1992) ("Such clauses, which have long been staples of federal contracts, are intended 'to prevent bidders from increasing their bid prices to protect against misfortunes resulting from unforeseen developments, and thus avoid turning a construction contract into a "gambling transaction."' (quoting *J.F. Shea Co. v. United States*, 4 Cl. Ct. 46, 50 (1983)); William S. Alldredge, *Allocation of Risks*, in 1 *CONSTRUCTION RISKS*, *supra* note 79, at 43 ("[O]wner must assume the risk in order to achieve realistic bid prices."); Howard W. Ashcraft, Jr., *Avoiding and Managing Risk of Differing Site Conditions*, in *DIFFERING SITE CONDITIONS CLAIMS* at 1, 4 (Robert F. Cushman & David R. Tortorello eds., 1992 & Supp. 1995) [hereinafter *CLAIMS*]; Steven C. Sanders, *Unanticipated Environmental Costs in Construction Contracts: The Differing Site Conditions Clause as a Risk Allocation Tool*, 10 J. NAT. RESOURCES & ENV'T L. 53, 57 n.26 (1995) ("This clause promotes the advantages of the competitive bidding system by allowing bidders to submit their lowest possible bid." (quoting RICHARD J. BEDNAR ET AL., *CONSTRUCTION CONTRACTING* 571 (1991))).

81. *Youngdale*, 27 Fed. Cl. 516, 527 n.19 (1993).

82. Ashcraft, *supra* note 80, § 1.4, at 4 (footnote omitted); see also Solomon Ribakoff, *Construction Contract Arrangements*, in 1 *CONSTRUCTION RISKS*, *supra* note 79, at 83, 87.

83. See *Hallmark Electrical Contractors, Inc.*, 87-2 B.C.A. (CCH) ¶ 19,870 (1987) ("While [the contractor] is not required to anticipate the worst, it cannot anticipate hitting only the best from within the usual range of hardness we see here.").

84. See STEVEN G.M. STEIN, 1 *CONSTRUCTION LAW* ¶ 5.07[viii], at 5-254.8 (1995) ("After balancing the costs of the inclusion of contractor contingencies against the risk of being obligated to pay legitimate claims for unforeseen conditions, both the AIA and the government have opted to include 'differing site conditions' clauses in their standard forms." (footnotes omitted)); see also David G. Hammond, *Minimizing Risks and Mitigating Losses*, in 1 *CONSTRUCTION RISKS*, *supra* note 79, at 133, 134 ("In fact, the owner may have increased costs for thus passing off the risks as the contractors are smart enough to have recognized that considerable risks do exist and they make

regularly, the differing site condition provision should be cost-reducing.

b. The Differing Site Condition Provision Reduces Litigation by Imposing a Duty to Modify the Contract

The differing site condition provision, in theory, should reduce the tendency of contracting parties to litigate or arbitrate claims. Unlike the common law, which permits but does not require modification for changed circumstances, the provision imposes upon the parties a duty to negotiate a modification to the contract.⁸⁵ Where a construction contract contains a differing site condition provision, the owner must negotiate a new price for the unanticipated work.⁸⁶

Despite the assumption that the clause promotes flexible, negotiated solutions to unanticipated difficulties during contract performance, no one doubts that the clause generates a tremendous amount of litigation.⁸⁷ The

suitable, not to say sometimes generous, allowances for contingency in their bids. In this way the owner usually winds up paying for possible untoward events even if they do not actually occur on the job.”).

85. See Sanders, *supra* note 80, at 57 n.26 (1995) (“It provides a contractual remedy (when the conditions are met) through negotiation rather than litigation.” (quoting RICHARD J. BEDNAR ET AL., CONSTRUCTION CONTRACTING 571 (1991))).

The requirement to adjust the contract (departing from the common law) is essential, for as Scott notes, “once contract risks are initially distributed, each party has less incentive to accommodate the other’s subsequent request for adjustment.” Robert E. Scott, *Conflict and Cooperation in Long-Term Contracts*, 75 CAL. L. REV. 2005, 2008 (1987).

86. Both the federal regulations and the AIA documents permit the owner to “terminate for convenience.” Ashcraft, *supra* note 80, at 20.

Termination for convenience is the ultimate contract safety valve and has several uses relevant to differing site conditions claims. First, when it becomes apparent that the differing site condition makes it impossible to deliver the project within the owner’s economic abilities or projections, the owner can abandon the project without further liability.

Ashcraft, *supra* note 80, at 20.

However, under the termination for convenience provisions, the owner must compensate the contractor, including reasonable profit, for the work already performed even if no economic benefit has been derived from the progress made. See *id.* An owner, depending upon the circumstances, may find going forward less onerous than stopping performance altogether. See Michael W. Clancy, *1995 Year in Review: The Federal Circuit’s Government Contract Decisions*, 25 PUB. CONT. L.J. 537, 577 (1996) (stating the termination for convenience clause alters the contractor’s favorable rights at common law for breach and gives the government broad rights to terminate the contract without allowing recovery for anticipated profits).

87. See STEIN, *supra* note 84, ¶ 5.07[viii] (“The possibility of encountering conditions which are different from those expected is one of the few constants in the construction industry.”); McClure, *supra* note 52, at 139 (“The Differing Site Conditions clause has been the subject of much litigation between construction contractors and the government.”); see also JOHN R. CLARK, USING AND UNDERSTANDING ENGINEERING SERVICE AND CONSTRUCTION CONTRACTS 72 (1986) (“It is fair to say that differing site conditions have been the subject of more claims between the parties than any

differing site condition provision, in its current form, is probably less effective at reducing litigation than it could be because the all-or-nothing stakes are so high. While under a differing site condition provision the owner must concede a duty to modify the contract for differing site conditions, the owner can, nevertheless, dispute the existence of a valid differing site condition claim or the amount of the adjustment owed. Thus, the general duty to adjust the contract price does not necessarily reduce disputes regarding whether to adjust the contract in a particular case and, if so, to determine by how much the contract should be adjusted.

The common law also fosters its share of litigation because of its abundant escape valves for the contractor trapped in a losing contract as a result of unforeseen conditions at the work site.⁸⁸ Moreover, without the dispute resolution and management provisions found in the standard form contract documents and the federal provisions, the common law promotes an adversarial rather than negotiated resolution of disputes. Thus although imperfect, relative to the common law, the standard form and government contracts better facilitate nonadversarial resolutions of disputes.

c. The Differing Site Provision Protects the Bidder Pool

The differing site condition provision spares contractors from inordinate losses associated with changed circumstances and thus protects their financial well-being. A large owner, especially the federal government, may have an interest in protecting and maintaining a financially healthy pool of qualified bidders for its projects and find this desirable even

other matter that has arisen during construction."); CLAIMS, *supra* note 80, at i ("Given the physical uncertainties inherent in any construction project and the widespread use of differing site condition clauses, it is not surprising that a large number of these claims occur.").

On the other hand, attempts to transfer the risk to the contractor, such as by the use of exculpatory clauses concurrently with differing site condition provisions, also generates a fair share of litigation. See Max W. Strauss, *Risk and Liability Sharing: The Owner's View*, in 1 CONSTRUCTION RISKS, *supra* note 79, at 28 ("As a matter of fact, it frequently doubles their exposure to some risks; once in the form of bid contingencies and again in having the clause held invalid either in arbitration or litigation.").

88. The contractor could seek relief based upon noncontractual claims of negligence, fraud, misrepresentation, breach of warranty, or other equitable doctrines such as mutual mistake. The contractor would assert, for example, that misrepresentations about the job site induced the contractor's low bid. See Alan S. Pralgever, *Common Law Theories for Recovery*, in CLAIMS, *supra* note 80, at 95; see also Kenneth M. Cushman et al., *Contractor's Rights and Duties: Bid Disputes and Associated Problems, Differing Site Conditions and Site Inspection Clauses, Change Orders, and Contract Technical Defenses*, in DRAFTING CONSTRUCTION CONTRACTS AND HANDLING CONSTRUCTION LITIGATION: PREPARING FOR THE "NEW" PUBLIC AND PRIVATE WORKS, at 61, 91-99 (PLI Real Estate Law and Practice Course Handbook Series No. 391, 1993) (citing cases).

though it increases its own costs.⁸⁹ After all, these large owners conduct business through bidding and each needs a pool of bidders in order to ensure competition.⁹⁰ Additionally, the large owner may require extremely specialized work that only a small group of contractors can perform.⁹¹ One very costly job may drive a contractor out of business, eventually hurting the large owner who requires specialized services in multiple contracts. Absorbing the cost of unforeseen conditions protects the industries upon which the large owner depends. Moreover, contractors may elect not to bid on high-risk projects, finding the risks unacceptably high. In the long run, a reluctance to compete among qualified bidders injures the large owner doing business via a bid process.⁹²

d. The Differing Site Provision Keeps Down the Costs of Preparing Bids and Doing Business

A differing site condition clause relieves a bidding contractor from the Hobson's choice of either conducting extensive site exploration (for a job it may not win) or accounting for contingencies in its bid (and thus overpricing its bid).⁹³ Furthermore, pre-bid exploration costs by the successful bidder are eventually passed on to the owner during the life of the awarded contract. Extensive pre-bid exploration by each bidder also raises the cost of doing business generally.⁹⁴ Therefore, it is in the interest of owners doing business by bids to provide as much information about sites as possible and to discourage bidders from conducting

89. See *Foster Constr. C.A. & Williams Bros. Co. v. United States*, 435 F.2d 873, 887 (Ct. Cl. 1970) (stating that contractors "will have no windfalls and no disasters").

90. See CARL A. ERIKSON ET AL., CONSTRUCTION ENG'G RESEARCH LABORATORY, PRELIMINARY INVESTIGATIONS OF RISK SHARING IN CONSTRUCTION CONTRACTS, REP. NO. CERL-IR-P-88, at 17 (1978); T.G. McCusker, *Risk Allocation*, in 2 CONSTRUCTION RISKS, *supra* note 79, at 57 ("In fact, the public benefit is better secured if the contractor stays in business.").

91. See *Acme Process Equip. Co. v. United States*, 347 F.2d 509, 530 (Ct. Cl. 1965) (noting that when awarding bid to new contractor, government contemplated as a benefit that it would "broaden the manufacturing base"), *rev'd on other grounds*, 385 U.S. 138 (1966).

92. See *Sanders*, *supra* note 80, at 56 n.21 (1995) (citing John F. Seymour, *Liability of Government Contractors for Environmental Damage*, 21 PUB. CONT. L.J. 491, 522 (1992)).

93. See *Foster*, 435 F.2d at 887 ("Reliance [on data supplied by government] is affirmatively desired by the Government, for if bidders feel they cannot rely, they will revert to the practice of increasing their bids.").

94.

If the contractor could not rely on his own reasonable expectations or contract representations, and had to perform expensive testing and investigating, the costs would be passed on to the government. . . . "If every bidder were required to perform all the investigations, even though the chance of receiving the bid was remote, the number of bids would decrease and the dollar amount of the bids would increase."

McClure, *supra* note 52, at 143 (quoting *Robert E. McKee, Inc. v. City of Atlanta*, 414 F. Supp. 957, 959 (N.D. Ga. 1976)).

extensive, independent investigations that add to the cost of doing business.⁹⁵

The allocation of risks for unknown site conditions to the owner may be appropriate for the large owner with extensive knowledge or ability to obtain data about its site. However, the differing site condition provision requires contractors and owners to make subtle, sophisticated distinctions between unknown or unusual conditions and those that should have been reasonably anticipated.⁹⁶ Contractors remain obligated to conduct reasonable site inspections and to discover that which reasonable, intelligent contractors would discover.⁹⁷ Under the differing site condition provision, the scope of the site inspection becomes one source of dispute, whereas under the common law all site inspection responsibilities are assigned to the contractor. Thus, the clause imperfectly relieves the contractor of pre-bid site inspection and instead creates a breeding ground for litigation.⁹⁸

e. The Differing Site Condition Provision Moves Performance Forward

Under standard form and federal contracts, performance of the contract is expected to continue even when disputes arise or conditions change.⁹⁹ Equitable adjustments may be arbitrated or litigated if they cannot be resolved as demands for adjustments are made but performance moves forward nevertheless.¹⁰⁰ In fact, the standard contract documents and the

95. See Richard J. Kendall, *Changed Conditions as Misrepresentation in Government Construction Contracts*, 35 GEO. WASH. L. REV. 978, 979-80, 982 (1967) (explaining that since 1926 the federal government has accepted the risk of unforeseen physical conditions: "The cost of exploration would probably ultimately rest with the Government which would, in effect, be paying many times for the same information.").

96. See *supra* notes 47-72 and accompanying text.

97. See *Servidone Constr. Corp. v. United States*, 19 Cl. Ct. 346, 373 (1990), *aff'd*, 931 F.2d 860 (Fed. Cir. 1991); see also *Youngdale & Sons Constr. Co. v. United States*, 27 Fed. Cl. 516, 533 (1993).

98. In *Servidone*, for example, the court faulted *Servidone* for not discussing the job with more experienced contractors, for not attempting to verify the boring logs, and for not cutting a test trench. See *Servidone*, 19 Cl. Ct. at 373. Thus, the clause does not relieve the contractor of site inspection responsibilities. Instead it creates an ill-defined "reasonable contractor" standard by which to resolve their dispute. The common law, with its absolute allocation, at least left the contractor and owner no room for dispute as to what the contractor must do pre-bid. See also Sweet, *Dominant Actor*, *supra* note 78, at 329 (illustrating that AIA documents are imperfect at proper risk distribution and risk avoidance).

99. See Lee, *supra* note 9, at 1084-86 (stating that construction contracts are designed to anticipate changes and provide methods to resolve disputes).

100. See Ian R. MacNeil, *Contracts: Adjustment of Long-Term Economic Relations Under Classical, Neoclassical, and Relational Contract Law*, 72 NW. U.L. REV. 854, 866 (1978) [hereinafter MacNeil, *Adjustment of Long-Term Relations*] (explaining that AIA's designation of an

federal regulations are designed to preserve contractual relations by providing a process to resolve disputes during the project or to reserve disputes until after completion.¹⁰¹

Although the modern common law rule permits modifications during performance at the owner's option, unlike the standard form documents and the federal regulations, there is no mechanism to encourage negotiations while simultaneously requiring continued performance. Under the common law, the contractor's threat to abandon a project if the contract is not modified is part and parcel of the coercion that the pre-existing duty rule sought to prevent. The federal and standard form differing site condition provision, coupled with the claims procedures, is therefore superior to the common law in preventing unresolved disputes from destroying the contractual relationship.¹⁰² However, because entitlement to an adjustment depends upon proving the existence of a condition that warrants the adjustment and proving the amount of the adjustment, there remains sufficient uncertainty to encourage litigation of disputes.¹⁰³

f. The Differing Site Condition Provision Reduces the Contractor's Incentive to Recover Costs Inappropriately

Under the common law, contractors that find themselves in financially losing contracts due to unanticipated conditions may attempt recovery through indirect and improper methods.¹⁰⁴ For example, they may neglect the job and spend their time on more profitable work or they may cut corners and compromise quality in ways that are imperceptible to the

architect to resolve disputes between an owner and a contractor provides flexibility in the relationship between the parties); see also Sweet, *Dominant Actor*, *supra* note 78, at 326-29 (explaining that AIA documents provide for continuation of the project during disputes). See generally Thomas J. Stipanowich, *Beyond Arbitration: Innovation and Evolution in the United States Construction Industry*, 31 WAKE FOREST L. REV. 65 (1996) (describing the arbitration process and stating that the United States construction industry is an innovator in the field of alternative dispute resolution).

101. See Lee, *supra* note 9, at 1084-86 (explaining that construction contracts are not static documents, but are designed to anticipate changes and provide "protocols to resolve disagreements").

102. See Thomas R. Kuesel, *Allocation of Risks*, in CONSTRUCTION RISKS, *supra* note 79, at 63 ("Unreasonably burdening the contractor does not necessarily rid the owner of the risk. Default on the part of the contractor in whole or in part is always a very real prospect.").

103. See Scott, *supra* note 85, at 2021 (noting that even with adjustment clauses, the threat of substantial losses precludes "effective bargaining over the appropriate responses to an adjustment contingency").

104. See JUSTIN SWEET, LEGAL ASPECTS OF ARCHITECTURE, ENGINEERING AND THE CONSTRUCTION PROCESS § 25.04, at 542 (5th ed. 1994) [hereinafter SWEET, LEGAL ASPECTS] ("[T]he ruthlessly competitive construction market may mean that contractors do not include contingencies for subsurface conditions into their bid prices. While this may appear to be beneficial to the owner, the contractor who loses money is likely to make a claim and may win it; in any event, all the parties will suffer extensive claims overhead.").

owner.¹⁰⁵ The differing site condition provision promotes direct recovery rather than indirect and inefficient recoupment of costs. Providing this mechanism for direct recovery of unanticipated costs reduces indirect recovery through inferior performance, a result benefiting both parties.

2. Normative Justifications

a. The Fair Price Principle

The differing site condition provision, in addition to promoting lower bids, also ensures fairer compensation for work. The clause achieves two goals of the government, that it pay a fair price and that it protect its business partners. The clause achieves these goals by sacrificing the predictability of the so-called fixed-price contract.¹⁰⁶ However, ensuring that the "contractor is paid for what [it] does and conversely that the Government gets something for every dollar that it spends" was, in fact, an express federal goal when the government first adopted the clause.¹⁰⁷ Adoption of a differing site condition provision represents a decision to de-emphasize the significance of the fixed price in favor of the fair price concept.

Either the owner or the contractor can ask for an equitable adjustment. Therefore, the fair price concept can work to either party's advantage under the federal and standard form provisions.¹⁰⁸ However, an owner's difficulty in detecting a contractor's cost savings by claiming better-than-expected site conditions is obvious. While a contractor will assert its need for upward equitable adjustments, it is unlikely that a contractor will volunteer that an owner is entitled to such an adjustment downward.

105. See Max W. Strauss, *Risk and Liability Sharing: The Owner's View*, in 1 CONSTRUCTION RISKS, *supra* note 79, at 28 ("[C]ontractors who having, either deliberately or incompetently submitted an inadequate bid, attempt[] to compensate by submitting every minor and insignificant deviation, whether detrimental or beneficial, as a claim for changed conditions.").

106. See Kendall, *supra* note 95, at 985 (explaining that the federal government's goal is both to ensure that the contractor is paid for all work and that the government receives work for all money paid).

107. *Id.* at 985 & n.65 (quoting Proceedings of the Meetings of the Interdepartmental Board of Contracts and Adjustments, Washington D.C., 427 Meeting at 2, August 22, 1930).

108. See Federal Acquisition Regulations, 48 C.F.R. § 52.236-2(b) (1996) ("If the conditions do materially so differ and cause an increase or decrease in the Contractor's cost . . . , an equitable adjustment shall be made"); AIA DOCUMENT A201, *supra* note 42, § 4.3.6 ("[I]f [the conditions] differ materially and cause an increase or decrease in the Contractor's cost . . . , [the Architect] will recommend an equitable adjustment"). See generally T.F. Scholes, Inc. v. United States, 357 F.2d 963 (Ct. Cl. 1966); McClure, *supra* note 52.

Although such adjustments are rarely sought or recovered,¹⁰⁹ the fair price principle applies to both parties equally.

b. Prevents Unjust Enrichment

The differing site condition provision merely requires payment for the work the contractor actually performs. Arguably, an owner is unjustly enriched under the common law because the owner receives work beyond that anticipated at the time of making the contract without paying for it. This argument assumes that the owner initially intended to bargain for a fair price for work performed at the time of contracting.¹¹⁰ If the owner desired a fair price, the owner expected neither that the bid price included work that would not be done (the contingency price) nor that the price omitted work that would actually be done (work for the differing condition). To the extent that both parties intended this fair price rather than the gamble, the opportunistic refusal to modify the contract should not be rewarded as it is under the common law.¹¹¹ In order to achieve the fair price principle, contracts must allow mid-performance modifications as the differing site condition clause demands.

However, the common law view is not that the extra work represents an unfair benefit to the owner; rather, the common law views the fixed price as a risk allocation device. The contractor voluntarily assumed the risk of extra work. The common law assumes that in a fixed-price contract the owner desired and bargained for the fixed price rather than a fair price. Thus, under the common law, the owner is not unjustly enriched and the contractor generally is not entitled to *quantum meruit* price adjustment.¹¹² However, one author suggests that contractors tend

109. See, e.g., *KECO Indus., Inc. v. United States*, 364 F.2d 838, 850 (Ct. Cl. 1966); see also *Mason*, *supra* note 52, at 20 ("In practice, the owner can seldom negotiate a contract price change based on the contention that the site condition made the work less expensive than contemplated by either party.").

110.

It is not unreasonable to posit an unarticulated "duty to adjust," an obligation on the part of one party not only to act in good faith, but also to agree to an adjustment of the contract terms in order to avoid any fortuitous advantage at the expense of the other party.

Sheldon W. Halpern, *Application of the Doctrine of Commercial Impracticability: Searching for "the Wisdom of Solomon,"* 135 U. PA. L. REV. 1123, 1129 (1987).

111. See Strauss, *supra* note 105, at 28; see also Max E. Greenberg, *Contractual Arrangements*, in 2 CONSTRUCTION RISKS, *supra* note 79, at 100, 104 ("The Owner - not the Contractor, in estimating his probable costs should include a substantial percentage to cover the risks of uncertainties. This should be reflected in the appropriation. It is better for the Owner to do it initially instead of paying it as a hidden cost in the contract price with increased costs of litigation if the contractor finds his contingency item inadequate. If done properly, contractors' bids will be well below the appropriation. Funds will then be readily available to satisfy claims for those risks actually realized.").

112. See *American Demolition, Inc. v. Hapeville Hotel Ltd. Partnership*, 413 S.E.2d 749, 752

to *undervalue* contingency risks.¹¹³ If this is so, then in a common law governed contract, the owner arguably does not pay a sufficient sum for the favorable risk allocation and is unfairly rewarded by the initial undervaluation of the risk.

c. The Ability to Equitably Adjust the Contract Protects Long-Term Relationships

The government's interest in maintaining a healthy pool of qualified bidders includes not only its economic interest in protecting potential bidders, but also the government's national interests.¹¹⁴ The clause protects the financial well-being of the government's pool of bidders and business partners, and recognizes the mutual benefit gained from the contractor's continued existence.¹¹⁵ When contractors and owners share an interest in a continued relationship, in the other's continued ability to perform, or in the continued availability of certain services, then protecting contractors from losses that threaten their continued existence serves the long-term interests of both.¹¹⁶

d. The Differing Site Condition Provision Allocates Risks to One with More Knowledge

While the differing site condition provision is intended for claims in which neither party knew nor should have reasonably expected such a

(Ga. Ct. App. 1991) (holding no recovery in quantum meruit for risks associated with subsurface conditions in demolition contract at common law); *S & M Constructors, Inc. v. City of Columbus*, 434 N.E.2d 1349, 1351 (Ohio 1982) (holding no recovery of compensation on the ground of unjust enrichment for that which was agreed should be given in return). *But see* *W.F. Magann Corp. v. Diamond Mfg. Co.*, 580 F. Supp. 1299, 1315 (D.S.C. 1984) (holding that subcontractor may recover quantum meruit damages for unexpected site conditions), *aff'd in part and rev'd in part*, 775 F.2d 1202, 1208 (4th Cir. 1985); *Steinberg v. Fleischer*, 706 S.W.2d 901, 906-07 (Mo. Ct. App. 1986) (permitting recovery in quantum meruit).

113. *See* Lee, *supra* note 9, at 1100 ("[T]he dynamics of public competitive bidding make shedding of risk that is out of the contractor's control inherently unfair because it is a non-negotiable term that the contractor is coerced into undervaluing.").

114. *See id.* at 1091 (discussing how public contracts serve multiple purposes, including: constructing infrastructure as a means of encouraging private sector growth, stimulating the economy, creating jobs, fostering social and economic goals, and promoting small businesses, minority businesses, and local manufacturing).

115. *See* Raymond E. Levitt et al., *Allocating Risk and Incentive in Construction*, 106 J. CONSTR. DIV., Sept. 1980, at 297, 297-98 (noting U. S. Department of Transportation concern that costs of underground projects (subways, water tunnels, and other underground facilities) preclude the viability of underground transportation due to misallocation of risks); *see also* Lee, *supra* note 9, at 1092.

116. *See* Scott, *supra* note 85, at 2007 (noting that the commercial contract goal is to distribute risk "in the least burdensome way," then "to adjust initial risk assignments in light of subsequent events so as to realize greater benefits from their joint enterprise").

condition to exist,¹¹⁷ the government or large owner usually has substantial knowledge or the ability to acquire such knowledge¹¹⁸ about the nature of the latent conditions and the risks involved at the site.¹¹⁹ Furthermore, the large public or private owner has more ability and time to conduct site exploration and investigation than does a contractor who must confine its inspection to a brief pre-bid period. The sophisticated owner, aware of the retained risk of subsurface or latent conditions and able to investigate, then makes a conscious decision as to the extent of investigation desired versus the amount of tolerable risk of unforeseen conditions.¹²⁰ With knowledge of the potential risks, an owner is able to budget for contingencies just as the contractor did at common law. Moreover, the overall business costs are lower when site inspection is assigned to the owner rather than duplicatively assigned to each potential bidder.

Furthermore, the clause actually encourages the owner with knowledge about latent site conditions to share that information with contractors during the bid phase in order to secure accurate bids.¹²¹ On the other hand, the common law gives owners little incentive for candor concerning the site, because absent misrepresentations the owner is rewarded by a contractor's optimistically low bid.

117. See *supra* note 52 for the difference between Type I and Type II differing site condition claims.

118. See *Youngdale & Sons Constr. Co. v. United States*, 27 Fed. Cl. 516, 527 n.21 (1993) ("[T]he government is in a better position to provide the contractor with the necessary information about site conditions . . ."); *Foster Constr. C.A. & Williams Bros. Co. v. United States*, 435 F.2d 873, 881 (Ct. Cl. 1970). But see *Watkins & Son, Inc. v. Carrig*, 21 A.2d 591, 592 (N.H. 1941) (holding that at common law, the contractor "was unwise in taking chances").

119.

Differing-site-condition and changed-condition provisions were instituted in government contracts to avoid the uneconomic bidding practices which preceded them. The traditional practice of "all risk" bidding compelled the contractor to include contingencies to cover unforeseen conditions in every bid. The practice has now given way to more sensible clauses designed to shift this risk of the unknown to the owner. Therefore, the owner has a very great practical motivation to assure that he has taken reasonable steps to assemble and fully disclose all relevant information

STEIN, *supra* note 84, ¶ 5.07, at 5-273.

120. See Norman A. Nadel, *Allocation of Risks--A Contractor's View*, in 1 CONSTRUCTION RISKS, *supra* note 79, at 61, 62-63.

121. See STEIN, *supra* note 84, ¶ 5.07, at 5-273 ("[O]wner has a very great practical motivation to assure that he has taken reasonable steps to assemble and fully disclose all relevant information.").

C. A Delicate Balance: The Potential for Abusing the Bidding Process and Efforts at Reform

1. Disadvantages of the Provision Outside of the Federal Arena

If contractors underbid contracts, anticipating that they can make up their losses on claims, then three problems occur. First, the owner pays more than initially budgeted for the work and suffers the resulting problems related to unexpected and unbudgeted expenses. Second, the most deserving contractors, those who abide by ethical tenets while bidding and submit the fairest and most accurate bids, are rejected while the least ethical bidders are rewarded.¹²² Thus, the entire bidding process is undermined. Finally, the transaction costs of the claims process further increases the cost of additional work.¹²³ The more "flexible" the contract, the more opportunities to recover compensation despite an initial, unrealistically low bid.

The federal government is able to balance these risks for three reasons: 1) an elaborate claims process,¹²⁴ 2) its ability to bear the costs of monitoring and resisting claims, and 3) because contractors are willing to treat the federal government fairly in order to preserve their long-term relationships with the government. However, other owners do not share the interests or resources of the federal government and may find the goals of the differing site provision irrelevant to them and its management burdens too great. Small owners have little or no interest in long-term relationships with contractors. Small owners also lack any desire to protect the contractor or the construction industry.¹²⁵ Furthermore, unlike

122. See *Wiechman Eng'rs v. State ex rel. Dep't of Public Works*, 107 Cal. Rptr. 529, 536 (Cal. Ct. App. 1973) (noting that this situation is "grossly unfair to the prudent and careful contractor who is frequently underbid by a careless competitor"). But see *Lee*, *supra* note 9, at 1100-01 (arguing no contingency should be assigned to a contractor in a public contract because inclusion encourages undervaluing risk: "The contractor who undervalues or ignores such risk is rewarded because it reflects in a lower bid price."). On the other hand, this Article argues that a liberal claims policy encourages the same undervaluation and rewards the same inaccurate bidder. Cf. Jon D. Markman, *No Light at End of the Tunnel*, L.A. TIMES, Dec. 21, 1995, at B-1 (recounting why contractor's history of filing claims); Ted Rohrlach, *Competing Interests Building a Subway--It Isn't Boring Series*, L.A. TIMES, Sept. 14, 1987, at 1 (discussing how contractors file claims "[a]nytime something costs . . . more than he thought it would; "nearly every major construction project leads to claims and litigation").

123. See *P.T. & L. Constr. Co. v. New Jersey Dep't of Transp.*, 531 A.2d 1330, 1341 (N.J. 1987) ("[T]he State argued that it 'would rather pay up front than through litigation' in order to ensure better budget predictions and public confidence in government spending. But once a policy choice in bidding is made, it should be respected.").

124. See *Vom Baur*, *supra* note 8, at 159 (noting and comparing the sophistication of the federal claims process with that of most state and municipal governments); see also *Baker*, *supra* note 8, at 270 (discussing how some states are developing contract dispute courts akin to the federal system).

125. See *Scott*, *supra* note 85, at 2048 ("The mere anticipation of mutually rewarding future

the federal government, other owners lack an elaborate contract claims procedure and other policing mechanisms.¹²⁶ An owner resisting claims for equitable adjustments because of alleged differing site conditions under the current system must be vigilant against contractors that make claims for ordinary or expected conditions that should have been included in a proper bid. To ensure the clause functions as intended, an owner must be prepared to litigate improper claims.¹²⁷ Monitoring the contract and the claims process produces attendant transaction costs that add even more to the cost of projects.

2. A Modest Proposal: Risk-Sharing by Eliminating the Contractor's Recovery of Profit

The federal and standard form provisions, in totality, share the risks associated with construction projects by allocating risks to one or another party so that the overall contract becomes a model of risk sharing.¹²⁸ However, in the case of unforeseen circumstances, a fairer starting point for the contract clause might be risk sharing rather than risk allocation.¹²⁹ Neither the common law, assigning the risk to the contractor, nor the standard provisions, assigning the risk to the owner, share risks of unforeseen conditions between the parties. If the clause were modified to provide contractors with protection from the losses associated with a differing site condition but prevent contractors from realizing a fortuitous

transactions maintains the cooperative equilibrium"); see also Sweet, *Dominant Actor*, *supra* note 78, at 329 (stating that AIA claims procedures are less "workable" on small and mid-size projects).

126. Although required to incorporate federal provisions in grants-in-aid contracts, the federal courts do not have jurisdiction over contract disputes between the private parties. See Baker, *supra* note 8, at 285-86 (citing cases).

127. See Rohrlich, *supra* note 122, at 1 ("'Anytime something costs (a contractor) more than he thought it would, it's only human nature for him to assume it was a changed condition,' remarked John Fondahl, head of Stanford University's construction engineering and management program. 'Otherwise he would have recognized it when he bid the job'").

128. To the extent that the extra-contract and long-term values motivate selection of a differing site condition provision, risk sharing is also an appropriate contract goal. See MacNeil, *Adjustment of Long-Term Relationships*, *supra* note 100, at 900-01; see also Scott, *supra* note 85, at 2018 ("Risk-sharing arrangements should be preferred where the contingencies are too interactive to make such individual precautions meaningful."); Sweet, *Dominant Actor*, *supra* note 78, at 329-30 (stating that contracts should "place risk upon the participant who can most easily prevent harm or transfer risk to others;" however "drafting principles of the AIA do not, in my view, sufficiently stress management goals of efficiency and harm avoidance").

129. See Ian R. MacNeil, *THE NEW SOCIAL CONTRACT: AN INQUIRY INTO MODERN CONTRACTUAL RELATIONS* 27-28 (1980); see also MacNeil, *Adjustment of Long-Term Relations*, *supra* note 100; Narasimhan, *supra* note 26, at 1198 (proposing a model of shared losses for unallocated risks and noting a disincentive to litigate). See generally Halpern, *supra* note 110; Robert Hillman, *Contract Excuse and Bankruptcy Discharge*, 43 STAN. L. REV. 99 (1990).

profit as a result of the unexpected condition, then the risks would be shared (admittedly unequally) between the owner and contractor.¹³⁰

While recovery of profit is logically justified for ordered changes and even perhaps for Type I differing site conditions,¹³¹ there is no logical reason to include profit when neither party anticipated the condition. By eliminating recovery for any profit on differing site condition work, especially of the Type II kind,¹³² the contractor gives up the benefit it receives for an unforeseen condition (the profit) without suffering a loss, while the owner pays the costs of the unexpected condition without rewarding the contractor. Thus, both parties bear part of the financial risk of the unforeseen condition. While courts seldom arrive at the sharing solution independently and it is unlikely the common law will move toward risk sharing,¹³³ express risk-sharing provisions are appropriate in long-term relational contracts and contracts in which parties expect

130. Although not stated expressly, equitable adjustments include recovery for reasonable profit. See *Youngdale & Sons Constr. Co. v. United States*, 27 Fed. Cl. 516, 558 (1993) (holding that while federal regulation does not specifically provide for it, following prior case law, the plaintiff was "entitled to profit on its differing site condition equitable adjustment claim"); *Servidone*, 19 Cl. Ct. at 386 (stating that a "reasonable profit on additional costs allowed in connection with equitable adjustment"); *McClure*, *supra* note 52, at 174 ("The cost adjustment will be reasonable costs incurred to perform the differing work, plus profit . . ."). An example of excluding profits already exists within the federal regulations. The Suspension of Work provision allows contractors to recover costs during work suspensions but not lost profits. Federal Acquisition Regulations, 48 C.F.R. § 52.242-14 (1996) ("[A]n adjustment shall be made for any increase in the cost of performance of this contract (excluding profit) necessarily caused by the unreasonable suspension, delay, or interruption . . .").

131. A Type I claim depends upon proof of misleading information in the owner's contract documents. See *supra* note 52. On the other hand, a Type II claim is based upon conditions that neither party expected nor reasonably anticipated. See *supra* note 52. Thus, while no showing of fault is required on a Type I claim, owner misrepresentation may exist in a Type I claim. Misrepresentation is never a Type II issue. See *Foster Constr. C.A. & Williams Bros. Co. v. United States*, 435 F.2d 873, 881-82 (Ct. Cl. 1970).

132. See *supra* note 52.

133. There have been a few, notable decisions that opt for a shared-risk rule. These usually are in the context of contracts in which the parties shared a long relationship or mutual dependency. See, e.g., *Aluminum Co. of America v. Essex Group, Inc.*, 499 F. Supp. 53 (W.D. Pa. 1980) (providing equitable price adjustment where production cost index fails to account for dramatic increase in energy costs during a 17-year contract to convert aluminum ore into ingots); *Dynallectron Corp. v. United States*, 518 F.2d 594 (Ct. Cl. 1975) (adopting formula of shared costs in a joint venture failing for impossibility); *National Presto Indus. v. United States*, 338 F.2d 99, 111 (Ct. Cl. 1964) (the government contracted to purchase ammunition, neither party had special knowledge that the new production method called for in the contract would not work as anticipated, and holding that the additional costs should be borne equally by the government and the contractor. "It is at least equally logical and decidedly more just to divide the cost between the two parties, neither of whom can be properly charged with the whole."); *McGinnis v. Cayton*, 312 S.E.2d 765 (W. Va. 1984) (Harshbarger, J., concurring) (seeking reformation of a 75-year mineral lease that was no longer commercially reasonable). See also Richard E. Speidel, *Court-Imposed Price Adjustments Under Long-Term Supply Contracts*, 76 NW. U. L. REV. 369 (1981).

sustained, cooperative efforts.¹³⁴ In construction contracts, if the conditions were unforeseen, then there is no particular reason to allocate the entire risk to either party.

A risk-sharing clause may cure other problems fostered by either the common law or the differing site risk allocation approach.¹³⁵ Unlike either the common law or the differing site provision approach, with a risk-sharing approach each party bears sufficient risk to motivate responsible conduct during the bid process. Under the common law approach, the owner was rewarded for withholding information about the site in hope that an ignorant contractor would bid optimistically low. Unlike the common law approach, a risk-sharing approach gives the owner incentive to provide the contractor with information and to desire an accurate rather than an optimistically low bid. The unbid costs will eventually fall to the owner along with attendant transaction costs of the claims process. Under the current differing site condition provision, the contractor has an incentive to bid optimistically low and take the chance that equitable adjustments over the course of performance will make up any shortfall. At least then the contractor is in the game, and the flexibility of the contract will provide opportunities to recover any deficiencies in the initial bid. Unlike the current differing site condition provision approach, in a risk-sharing approach the contractor has an incentive to bid accurately rather than hope to recover through the claims process. Only by doing so will the contractor be fully compensated.

A risk-sharing approach also reduces the winner-take-all stakes of either the common law or the differing site condition provision and therefore should reduce litigation.¹³⁶ However, by eliminating only profit from the contractor's recovery under an equitable adjustment, the

134. See generally Richard Speidel, *The New Spirit of Contract*, 2 J.L. & COM. 193 (1982).

135. One author asserts that public work contracts are adhesionary and unfair to contractors as now written. The author argues that the government "should pay for all contingent conditions when and if they are encountered" or insure against the risk rather than pass it on to the contractor. See Lee, *supra* note 9, at 1118, 1121. However, the provisions found in both federal and AIA documents are typically considered negotiated because of the input from various groups at the drafting stage. Justin Sweet, on the other hand, notes that while AIA documents are regarded as negotiated contracts, the owners have been absent from the drafting of these provisions. See Sweet, *Dominant Actors*, *supra* note 78, at 322. Sweet suggests that risks are not well-allocated by the standard provisions and that owners "basically have been unrepresented in the AIA drafting process." *Id.*

136. See Steven McG. Bundy, *The Policy in Favor of Settlement in an Adversary System*, 44 HASTINGS L.J. 1, 26-28 (1992) (discussing why high stakes in litigation disfavor early settlement); Bruce L. Hay, *Fee Awards and Optimal Deterrence*, 71 CHI.-KENT L. REV. 505, 514 (1995) (noting that high stakes discourage settlement); Russell Korobkin & Chris Guthrie, *Psychological Barriers to Litigation Settlement: An Experimental Approach*, 93 MICH. L. REV. 107 (1994) (discussing psychological and economic impediments to settlement); Edward Yorio, *Federal Income Tax Rulemaking: An Economic Approach*, 51 FORDHAM L. REV. 1, 20-21 (1982) (discussing how the all-or-nothing approach reduces likelihood of settlement).

contractor remains protected from inordinate losses. Thus, the risk-sharing model continues to recognize the public owner's inherent ability to better absorb substantial losses (or terminate for convenience), its interests in protecting the contractor and the construction industry generally, and its desire to ensure that the contractor is fairly paid for the work performed. Finally, a risk-sharing approach is consistent with the overall goals of construction contract provisions, which were designed to encourage cooperation between parties.¹³⁷

Currently, the Model Procurement Code for State and Local Governments retains a differing site condition provision,¹³⁸ although state and local governments are not uniformly satisfied with the risk allocation.¹³⁹ Another alternative for state and local governments is to provide contract choice at the time bids are solicited.¹⁴⁰ The State of Hawaii, as part of a complete procurement law overhaul, provides alternative provisions selected by the state when putting the project out for bid.¹⁴¹ One alternative is modeled after the federal differing site condition provision.¹⁴² The second, like the common law, leaves the risk of unforeseen conditions on the contractor.¹⁴³ The election requirement ensures that the term will be consciously considered as a factor in pricing and permits the state to elect whether to pay up front in the form of higher bids or at the end through the claims process.¹⁴⁴ The election of one provision instead of another, however, will continue to wholly allocate risks to one or the other party.¹⁴⁵ The election of one alternative in a particular contract may

137. See *supra* note 101.

138. See Vom Baur, *supra* note 8, at 169.

139. See *City of Morton v. Minnesota Pollution Control Agency*, 437 N.W.2d 741, 748 (Minn. Ct. App. 1989) (discussing that municipalities unsuccessfully challenged the validity of a state rule imposing a two percent limit on grant amendments for increased costs due to differing site conditions where the state disburses federal grant monies to municipalities); see also SWEET, *LEGAL ASPECTS*, *supra* note 104, § 25.04, at 542 ("[M]ost private and many state and local public owners make information available to the bidders but use contractual disclaimers in an attempt to relieve themselves from any responsibility for the accuracy of the information."); John E. Beard III, *Contract Allocation of Risk of Differing Site Conditions*, in *CLAIMS*, *supra* note 80, at 32 (stating that many states and many municipalities avoid the clause if possible).

140. When not forced to include a provision by federal law, local governments often exclude the differing site condition provision. See Beard, *supra* note 139, at 32.

141. HAWAII ADMIN. RULES § 3-125-11 (Nov. 7, 1995).

142. See *id.* § 3-125-11(1).

143. See *id.* § 3-125-11(2).

144. Cf. *P.T. & L. Constr. v. New Jersey Dep't of Transp.*, 531 A.2d 1330, 1341 (N.J. 1987) ("State argued that it 'would rather pay up front than through litigation' in order to ensure better budget predictions and public confidence in government spending.").

145. The alternative to the federal provision is as follows:

The contractor accepts the conditions at the construction site as they eventually may be found to exist and warrants and represents that the contract can and will be performed under such conditions, and that all materials, equipment, labor, and other facilities re-

indicate which party is in a weaker position, rather than which party should properly bear the risk under the circumstances.¹⁴⁶ Thus, election between alternatives permits the owner to achieve the fixed price desired if that is paramount, but it solves little else.

IV. SHOULD THE SMALL OWNER PAY MORE TO AVOID THE RISK?

In the single construction transaction, particularly for the small owner or municipality with limited resources and infrequent construction projects, the differing site condition provision merely reallocates an unavoidable risk inherent in the construction contract.¹⁴⁷ The small owner shares few interests with the federal government in protecting relationships with contractors and industries.¹⁴⁸ The owner likely places more importance on the fixed price of a contract,¹⁴⁹ because the owner is less able than a large entity to bear unexpected costs.¹⁵⁰ Therefore, the owner who builds a single project should ask *who* should bear the cost of an unforeseen condition, rather than presume to enjoy any of the cost-saving

quired because of any unforeseen conditions (physical or otherwise) shall be wholly at the contractor's own cost and expense, anything in this contract to the contrary notwithstanding.

HAWAII ADMIN. RULES § 3-125-11(2); see also Sweet, *Dominant Actor*, *supra* note 78, at 335-36 (noting that AIA documents should provide alternative risk-allocation clauses within its contracts).

146. The National Association of Attorneys General proposed a differing site condition that was more favorable to the owner. It met with resistance. See Ellickson, *supra* note 79, at 2.

147. Treatment of risks falls into four categories: risk avoidance, risk abatement, risk retention, and risk transfer. See Mason, *supra* note 52, at 26. With a differing site condition provision, the owner both retains and transfers certain risks. Costs for reasonably anticipated conditions are transferred to the contractor and costs for unforeseen conditions are retained by the owner.

148. Cf. MacNeil, *Adjustment of Long-Term Relations*, *supra* note 100, at 861, 864 (discussing that current contracts employ risk-shifting, not risk-sharing, provisions).

149. As Sweet explains:

Certainly, cogent arguments can be made for the flexible approach. However, *some* owners would prefer a tight contract. If they can afford it, experienced private owners or public entities will draft their own contracts. They want a "tight" contract that will protect the contract price and time commitment. . . . Such owners will "tighten" their contracts for construction services by making the contractor bear the risk of unforeseen subsurface conditions AIA documents will not do this.

I do not suggest that the AIA's decision to publish flexible contracts is wrong. Yet the use by some owners—particularly experienced private or public entities—of tight contracts suggests that the market consists of a variety of customers, some of whom may wish a tight contract. While the AIA does recognize the value of fixed-price versus cost-type pricing, it does not publish a document that will meet the needs of an owner who wishes a *tight* fixed price contract for design or construction services.

Sweet, *Dominant Actor*, *supra* note 78, at 333 (footnotes omitted).

150. Cf. *id.* at 332 ("Clearly, any client believing that the basic fee will be all [he or] she will pay will be disappointed. The flexible nature of [AIA contract forms] offers much opportunity for adjustment. However, most adjustments will result in higher fees than the basic fee specified.").

effects the federal government anticipates from the provision.¹⁵¹ The construction industry's decision to include a differing site condition provision in its standard form contracts merely reflects a decision to reassign the contractor's common law gamble to the owner.¹⁵²

Importantly, although the clause shifts two significant common law rules that favored the owner, courts have generally held that AIA documents and other standardized construction contracts are "negotiated contracts" and interpret the contracts' clauses neutrally and not as adhesionary.¹⁵³ However, small owners, unlike the federal government

151. See Levitt, *supra* note 115, at 297 ("Proper allocation of risk must consider . . . [the] ability to absorb risk and incentive to manage risk, as well as the particular characteristics of the construction project contemplated."); Raymond E. Levitt et al., *Impact of Owner-Engineer Risk Sharing on Design Conservatism*, 110 J. PROF. ISSUES ENG'G, 157, 157 (1984); Justin Sweet, *Standard Construction Contracts: Some Advice to Construction Lawyers*, 40 S.C. L. REV. 823, 828-29 (1989) [hereinafter Sweet, *Advice to Construction Lawyers*].

152. "Such clauses, which have long been staples of federal contracts, are intended 'to prevent bidders from increasing their bid prices to protect against misfortunes resulting from unforeseen developments, and thus avoid turning a construction contract into a 'gambling transaction.'" *Municipality of Anchorage v. Frank Coluccio Constr. Co.*, 826 P.2d 316, 318 (Alaska 1992) (citing *J.F. Shea Co. v. United States*, 4 Cl. Ct. 46, 50 (1983), *aff'd*, 754 F.2d 338 (Fed. Cir. 1985)); see also Sweet, *Advice to Construction Lawyers*, *supra* note 151, at 829.

153. See SWEET, *supra* note 52, §§ 3.3-3.4, at 22-29; Sweet, *Dominant Actor*, *supra* note 78, at 324. AIA describes its drafting process as one of negotiations on an industry-wide basis:

Among all [the standard form] publishers, the American Institute of Architects (AIA) has probably the most refined and time-tested drafting process. It was in 1870 at its annual convention that the members of the AIA decided to establish a committee assisted by legal counsel for the drafting of contract forms. Today, the AIA still drafts its forms by committee, but even in its early efforts the AIA attempted to involve other groups. . . .

Over time the AIA has evolved a slow, cumbersome and expensive drafting process, but one that is necessary if it is to achieve a fair and durable balance among all the significant interests affected by the particular contract form. Generally, each AIA form is on a ten-year revision cycle

An important element of this committee process is having participants who, although surrogates for the eventual users of the forms, have close similarity to the users in background and outlook. First, AIA's Documents Committee is composed of practicing architects who have been appointed based upon their regional diversity and variety of practices. Next, the AIA opens the drafting process by soliciting and receiving comments from any and all interested parties. Comments are especially solicited from other organizations whose membership is composed of people with a special interest in the subject matter. Generally, the AIA prefers that representatives from those organizations be taken from the constituency—that they be actual owners, engineers, general contractors, subcontractors, sureties, and lawyers. Even though these individuals may be surrogates for the groups they represent, the closer they are to the actual experiences of their constituencies the more realistic their value judgments will be. . . .

The purpose of this process is to obtain an industry consensus on the standard forms before they are published. Each participant in this process will have to make trade-offs since nobody's self interest will exist in pure form; in this process it must exist in relationship to others' interests, and that is where the balancing comes in. In the end, it

that presents a take-it-or-leave-it contract to contractors, hardly enjoy the same, superior position as the federal government at the time parties enter a contract.¹⁵⁴ Furthermore, small owners have been the least represented group in drafting the standard form contracts.¹⁵⁵ Because the clause so dramatically shifts the expected, common law result, it may catch a small owner by surprise. However, its absence in the contract would not disadvantage either sophisticated contractors or owners.¹⁵⁶ Obviously, sophisticated parties draft their own provisions or, at the very least, acquaint themselves with the effects of standard provisions.¹⁵⁷ The standard form contract documents should reflect terms favorable to the least knowledgeable party in order to promote discussion and negotiation by one with knowledge.¹⁵⁸

On occasion, the differing site condition provision may be appropriate and desirable even for small owners. It gives some advantages to the small owner. When those advantages are important, the parties should include the provision. The clause encourages contractors to bid a fair price without building in the risk of contingencies and allows owners recovery for unexpectedly favorable conditions. For owners willing to take the risk and for whom the fixed price is less important, the provision

will not be a matter of getting everything you want but of getting the things you really need.

Ellickson, *supra* note 79, at 2-3.

154.

A primary difference between government contracts and commercial contracts is the absence of real negotiation. The contractor may either accept the contract with all its boilerplate or leave it. There is no give and take nor any 'meeting of the minds' as to the inclusion or the meaning of exculpatory language.

Kendall, *supra* note 95, at 987 (citations omitted).

155. "Even though the AIA, AGC [Associated General Contractors of America] and EJCDC take great pains to involve owners in the development of their contracts, the owner community is virtually nonexistent during the negotiations." McAlpine & Breuch, *supra* note 9, at 558; see also Sweet, *Dominant Actor*, *supra* note 78, at 322 (noting the "conspicuous absence of owners or groups with the owner's interests in mind" from the AIA document creation process).

156. See Sweet, *Dominant Actor*, *supra* note 78, at 332 (stating that experienced owners draft their own contracts).

157. See Ian Ayres & Robert Gertner, *Strategic Contractual Inefficiency and the Optimal Choice of Legal Rules*, 101 YALE L.J. 729, 746 (1991) ("[W]hen contracting is costless and parties have common knowledge of the default rule, the choice of default rules will have no impact on either the equilibrium of contractual obligations or social welfare.").

158. See *id.* at 761; Randy E. Barnett, *The Sound of Silence: Default Rules and Contractual Consent*, 78 VA. L. REV. 821, 895 (1992) ("[T]he law should adopt a conventionalist default rule reflecting the commonsense understanding of the community to which the rationally ignorant party belongs. If this term is objectionable to the knowledgeable party, it will then explicitly contract around the default rule, and the process . . . will call the new rule to the attention of the rationally ignorant party . . ."); Alex Y. Seita, *Uncertainty and Contract Law*, 46 U. PITT. L. REV. 75, 125 (1984) (noting that courts should adopt default rules that favor the ignorant party).

should be included. However, typically, the small owner probably does not expect a refund when agreeing to a fixed-fee contract, recognizing the firmness of the fixed-fee agreement on both sides. As with other consumer purchases, the owner likely expects the contractor will make a profit, does not expect a refund, and does not care whether the profit is large or small so long as the fixed fee represents a competitive price. Moreover, without a differing site condition provision in the contract, the contractor is forced to reveal potential latent and subsurface conditions that it suspects may exist in order to justify its inclusion of a contingency in the bid. Equipped with that information, the owner may elect to absorb the known risk if the contractor is able to give the owner the parameters of that risk.

However, without extra-contract justifications to warrant its inclusion, small owners benefit least from the positive effects of the differing site condition provision. Moreover, the negative effects of the mischievous clause are exacerbated by the relative inequality of risk-bearing ability, bargaining power, and knowledge. While the basic contract assumption for the government and larger entities--honest work for a fair price--may be prime, for the individual owner the basic contract assumption is more likely honest work for a fixed price. Unlike large owners, with long-term relationship concerns and extra-contractual concerns, the individual more likely desires a contract reflecting discrete transaction goals.¹⁵⁹

Finally, if the potential for harm is considered, the advantage of protecting the contractor instead of the large public owner is reasonable

159. Cf. MacNeil, *Adjustment of Long-Term Relationships*, *supra* note 100, at 856. MacNeil distinguishes discrete and relational contracts in terms of differing fundamental values. These differing values are well-reflected in contracting parties' choice between the common law and the differing site condition provision. For example, MacNeil explains that discrete relationships value presentation (perceiving, defining, and limiting the effect of the future) over uncertainty. *Id.* at 863. Discrete contracting commodifies the subject matter and in doing so limits the relationship to the substantive content of the agreement. *Id.* Discrete contracting strives for completeness. *Id.* On the other hand, relational contracts value future cooperation, flexibility, harmonizing conflicts internally, and preserving the relationship even in changing circumstances. *Id.* at 889-92.

In the case of a differing site condition, the common law treatment attempts to achieve "discrete" contract goals despite the long and uncertain path a construction project takes. The common law assumes that the contractor and owner considered the risk of unforeseen conditions and, through fixed pricing, allocated those risks to the contractor. Thus, the common law avoids uncertainty by assuming the completeness of the contract and through risk allocation. Moreover, the pre-existing duty rule favors certainty over flexibility.

The differing site condition clause, on the other hand, acknowledges relational contract values and attempts to facilitate a working relationship between the owner and the contractor. In so doing, the clause sacrifices the certainty of a fixed price. The owner and contractor are given a method to modify the contract to accommodate a changed condition rather than fixing both the price and the risk allocation at the time of contracting. Despite the adversity of changed circumstances, the clause requires the parties to continue the working relationship and to resolve their disputes. Importantly, employing the clause also serves relational values that are external to the contract.

in terms of the large public owner's ability to absorb the unexpected loss on a single project more easily than can the contractor.¹⁶⁰ Yet, just the opposite is true for smaller public entities and individuals.¹⁶¹

The small owner, including municipalities with shallower pockets than the federal government, is more likely to value the certainty of a fixed-price contract even if it means it may pay for a bid inflated by the risk of unforeseen contingencies. Additionally, small owners, unlike the large owners, typically lack the knowledge necessary to make informed

160. The following illustration demonstrates that because the harm, rather than the cost, may be less severe, risk is typically better borne by the deeper pocket:

Utility theory suggests that risk sharing should not be done on the basis of expected monetary value. If risks were allocated between a large owner such as the Federal Government and a contractor on an expected monetary value basis, it should make no difference in expected costs whether the owner or the contractor assumed the risk. For instance, assume there is a probability of 0.1 that a flood will occur and cause \$1,000,000 in damage to a construction project despite any possible precautions. On the basis of expected monetary value, it should make no difference whether the contractor or the owner assumed this risk; if the contractor assumed the risk, he would charge the owner $0.1 \times \$1,000,000$ or \$100,000 to cover the risk, while if the owner assumed the risk, he would similarly add \$100,000 to the expected cost of the project. The consequences if the flood did occur, however, could be quite different in the two cases. If the contractor had assumed the risk, the additional cost of \$900,000 above the expected \$100,000 might be a catastrophic loss resulting in bankruptcy or at least seriously impairing the contractor's ability to operate. The effects on the owner (the Federal Government) if it had assumed the risk would not be nearly so serious.

Because of the possibility of catastrophic loss, contractors do not appear willing to assume large risks on the basis of expected monetary value. They tend to include a sufficient contingency above and beyond the expected value of the loss so that even if the loss occurs the cost will not be catastrophic. For example, assume that the contractor could withstand a \$200,000 flood loss but that a \$300,000 loss would put him out of business. He might then be unwilling to assume the risk for less than \$800,000, thus limiting his maximum loss to \$200,000. In other words, the contractor in this case has a preference for particular dollar outcomes which is not in proportion to their dollar amounts. To reflect this risk aversion preference, utility theory assigns utility values to various dollar amounts by analyzing the decision-maker's preference for outcomes in a series of simple uncertainty lotteries. Whereas the contractor might have gone bankrupt in the short run if a flood occurred, a large owner might be better able to sustain a large loss on a particular project because the losses should average out in the long run over several projects and approach an expected value. His utility curve may approach that derived on an expected monetary value basis.

ERKSON, *supra* note 90, at 15.

161.

Given a risk that is relatively unforeseeable, relatively uncontrollable, and that unfairly benefits or detriments the party who must bear it, it is useful to examine the ability of the respective parties to bear the risk A large designer or contractor may, in fact, far exceed in size and capacity the small owner engaged in a single project such as one rural schoolhouse.

W. Stell Huie, *Identification and Nature of Risks*, in 2 CONSTRUCTION RISKS, *supra* note 79, at 15, 20-21.

decisions on the risk.¹⁶² Thus, it is often the contractor, rather than the small owner, who possesses superior knowledge about potentially adverse soil conditions, the hardness of rock found in the area, or the depth of the water table.

Moreover, small owners, unlike the federal government, are not as well-suited to effectively manage and litigate claims. The differing site condition provision is only effective when it is not used as a method to recover costs that should have been built into the contract price initially. The small owner lacks the ability to police the process and is therefore more vulnerable to the abuses connected with the provision. Furthermore, the small owner has neither a long-term relationship nor a desire to foster such a relationship with contractors. Likewise, the contractor has no long-term relationship to preserve with the small owner. Thus, the incentive to cooperate in order to promote future relationships is nonexistent. For these reasons, small owners are likely to prefer true fixed-price contracts instead of contracts with differing site condition provisions.

V. CONCLUSION

The differing site condition provision represents a risk allocation tool that contractors and the federal government contend allocates risk fairly and results in more precise bidding, fairer pay to the contractor, and lower costs to the owner in the aggregate. However, the clause generates disputes between contractors and owners as to whether conditions were actually unforeseen or should have been anticipated. Its inclusion gives contractors an opportunity to capture costs that should properly have been built into the original bid. The inclusion disadvantages careful bidders. The winner-take-all stakes and the inherent need to diligently police claims probably contribute to the number of disputes. Attendant costs of the claims process serve neither contractor nor owner. If the clause were rewritten to provide for risk sharing, the contractor's incentive to bid accurately would be maximized. Furthermore, risk sharing would cure common law risk allocation problems as well, giving owners incentives to conduct adequate site inspections and provide site information to bidders. Finally, reducing the stakes and making claim recovery less rewarding may promote negotiation and settlement.

Small owners should be given the opportunity to return to common law risk allocation rules if the owner places more value on a fixed price for work than on a low bid. In order to protect the small owner from this mischievous clause, at the very least, form contract documents should provide parties with alternative provisions in order to force negotiation

162. See Narasimhan, *supra* note 26, at 1147-48 (stating that experience shapes risk assumption).

on this important and frequently-litigated provision. As the form documents exist now, small owners will be caught unaware of the ramifications of this provision.